No. 77-648

In the Supreme Court of the United States

OCTOBER TERM, 1977

FEDERAL ENERGY REGULATORY COMMISSION,
PETITIONER

v.

PENNZOIL PRODUCING COMPANY, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

WADE H. MCCREE, JR.,
Solicitor General,

RICHARD A. ALLEN,
Assistant to the Solicitor General,
Department of Justice,
Washington, D. C. 20530.

ROBERT R. NORDHAUS,
General Counsel,

PHILIP R. TELLEEN,
Attorney,
Federal Energy Regulatory Commission,
Washington, D. C. 20426.

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The Solicitor General, on behalf of the Federal Energy Regulatory Commission,[1] petitions for a writ

[1] On September 30, 1977, pursuant to the provisions of the Department of Energy Organization Act (DOE Act), Pub. L. 95-91, 91 Stat. 565 and Executive Order No. 12009, 42 Fed. Reg. 46267, the Federal Power Commission ceased to exist. Its functions and regulatory responsibilities were transferred to the Secretary of Energy and the Federal Energy Regulatory Commission which, as an independent commission within the Department of Energy, was activated on October 1, 1977. Pursuant to Section 402(a)(1)(C) of the DOE Act, "the establishment, review, and enforcement of rates and charges for the transportation and sale of natural gas" in interstate commerce is "transferred to, and vested in," the Federal Energy Regulatory Commission. The "savings provisions" of Section 705 of the DOE Act provide for the substitution of the Federal Energy Regulatory Commission for the Federal Power Commission in pending litigation such as this case.

of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit.

OPINIONS BELOW

The opinion of the court of appeals (App. A, *infra*, pp. 1a-9a) is reported at 553 F. 2d 485. The initial opinion and order (No. 753) of the Federal Power Commission (App. D, *infra*, pp. 14a-26a) and its opinion and order (No. 753-A) denying rehearing (App. E, *infra*, pp. 27a-33a) are not officially reported.

JURISDICTION

The judgment of the court of appeals was entered on June 6, 1977 (App. B, *infra*, pp. 10a-11a). The Commission's application for rehearing was denied on September 1, 1977 (App. C, *infra*, pp. 12a-13a). The mandate of the court of appeals issued on September 9, 1977. On August 26, 1977, Mr. Justice Powell extended the Commission's time for filing a petition for a writ of certiorari to and including November 3, 1977. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 52 Stat. 831, as amended, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Whether the Commission has authority under the Natural Gas Act to permit lessee/producers of natural gas to pass through to interstate customers the producers' royalty costs that are based on the unregulated intrastate market price of natural gas.

2. Whether the Commission has authority under the Natural Gas Act to permit lessee/producers of natural gas to pay royalties "in kind" in the form of natural gas that the landowner/lessors can then sell on the intrastate market, and thus to permit producers to abandon certificated interstate service in quantities of gas solely for the financial benefit of the lessors.

STATUTES INVOLVED

Section 4(a) of the Natural Gas Act, 52 Stat. 822, as amended, 15 U.S.C. 717c(a), provides:

> All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is declared to be unlawful.

STATEMENT

Pennzoil Producing Company (Pennzoil) and Shell Oil Company (Shell) sell gas produced from the Gibson Field, in Terrebonne Parish, Louisiana to United Gas Pipe Line Company (United). The gas is produced under leases obtained by Pennzoil and Shell from Williams, Inc. (Williams) dated August 29, 1934, and July 24, 1952. Each lease provides for payment of a royalty equal to a fixed percentage (1/8 in the 1934 lease; 1/4 in the 1952 lease) of the value of

the gas produced, calculated at the "market rate" or "market price" prevailing at the well (App. D. *infra*, p. 13a).

Royalties under the leases have always been paid on the basis of the regulated rates at which the gas from the leaseholds has actually been sold in interstate commerce. However, in 1973 and 1974 Williams demanded payment by Shell and Pennzoil of royalties based on intrastate market values of natural gas, ranging from 35 cents to 70 cents per Mcf (1,000 cubic feet) for the period October 1, 1971 through December 31, 1973, and 70 cents per Mcf thereafter. These market values substantially exceeded the rate ceilings established by the Commission for the sales of gas by Shell and Pennzoil. By a letter of June 5, 1974 Williams purported to terminate the leases for alleged underpayment of royalties due under the leases (App. D, *infra*, p. 15a).

In 1974, Pennzoil and Shell filed a petition in a state court in Louisiana praying for a judgment declaring that Pennzoil and Shell were properly discharging their royalty obligations under the leases. Williams filed an answer and a counterclaim claiming royalty underpayments of $3,731,683.79 (App. D, *infra*, p. 16a).

Shell, Pennzoil and Williams subsequently entered into a settlement agreement, under which Pennzoil and Shell would apply to the Commission for authority to pay a royalty based, in essence, on the higher of 78 cents per Mcf or 150 percent of the highest area or national rate permitted by the Commission. Alternatively, Pennzoil and Shell would seek Commission authorization to abandon that portion of the gas sold under the leases which is attributable to Williams' royalty interest, *i.e.*, $\frac{1}{8}$ and $\frac{1}{4}$ of the gas produced under the 1934 and 1952 leases, respectively, so that that portion of the gas could be paid in kind to Williams for sale on the intrastate market. Accordingly, Pennzoil and Shell filed petitions with the Commission seeking special relief from the area and national rates established by the Commission to permit them to pass through to United the higher royalty rates called for in the settlement or, if this relief was denied, to permit them to abandon to Williams the portion of the gas produced under the leases that was attributable to Williams' royalty interests ("royalty gas") (App. D. *infra*, p. 16a).

After a hearing on the petitions, the Commission in January 1976 issued an opinion (App. D, *infra*, pp. 14a-26a) affirming the initial decision of the administrative law judge denying the requested relief. With respect to the requested rate increase, the Commission observed that while it did not have jurisdiction over the royalty owners or over the royalty payments made to them by producers,[2] it did have jurisdiction over the rates charged by producers to an interstate pipeline (*id.* at 21a-22a). The Commission concluded that it had no authority under the Natural Gas Act to grant the requested rate increase, stating (*id.* at 22a-23a):

[2] *Mobil Oil Corporation* v. *Federal Power Commission*, 463 F. 2d 256 (C.A. D.C.), certiorari denied, 406 U.S. 976.

> In the instant proceeding, the impetus of the settlement is the market value of the royalties and no consideration has been given to regulated rates. As such, we cannot permit any incremental royalty costs resulting from this settlement, or resulting from any judgment by a state court regarding royalty payments, to be passed on to the pipeline if these incremental royalty costs are based on any other factors than the regulated just and reasonable rate. On this point, we note the Supreme Court's warning in *FPC* v. *Texaco*, [417 U.S. 380], that the Commission is not free to equate just and reasonable rates with the prices for gas in the marketplace. Accordingly, we believe that we are not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates. A contrary result would not ". . . afford consumers a complete, permanent, and effective bond of protection from excessive rates and charges" [quoting from *Atlantic Refining Company* v. *Public Service Commission of New York*, 360 U.S. 378, 388].

The Commission also concluded that abandonment of the royalty gas to Williams should not be authorized under 15 U.S.C. 717f(b) (App. D, *infra*, pp. 23a-24a). The Commission found that the supply of natural gas in the leaseholds was not so depleted as to warrant cessation of service, and that the public convenience and necessity would not be served by granting an abandonment authorization that would "likely result in the subject gas being diverted from the interstate market to the intrastate market" (App. D, *infra*, p. 24a).[3] The Commission subsequently denied petitions for rehearing (App. E, *infra*, pp. 27a-33a) in an opinion and order reaffirming the reasons set forth in its initial opinion and rejecting contentions that this Court's decision in *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283, established the authority of the Commission to allow royalty costs based on market value to be passed on to pipelines. The Commission stated that "[w]hile indicating that relief on some grounds may be possible [*Mobil Oil Corp.*] does not state under what conditions relief should be granted, nor does it define when the right to gain relief matures" (App. E, *infra*, p. 29a).

The court of appeals reversed the Commission's orders (App. A, *infra*, pp. 1a-9a). The court viewed *Federal Power Commission* v. *Texaco Inc.*, 417 U.S. 380, as inapplicable, apparently because "[t]his case deals with royalty cost under specific leases" (*id.* at

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[3] Moreover, the Commission disagreed with Shell and Pennzoil that the Commission was forced to choose between losing 1/8 or 1/4 of the gas to the intrastate market as called for in the settlement, and possibly losing all of the gas if the leases were cancelled as a result of the state court litigation. Relying on its previous decision in *El Paso Natural Gas Co.*, 54 FPC 145, reversed *sub nom. Southland Royalty Co.* v. *Federal Power Commission*, 543 F. 2d 1134 (C.A. 5), certiorari granted, June 27, 1977, No. 76-1587, the Commission expressed the view that Williams could not unilaterally terminate deliveries to United if he terminated the leases. "[I]f the lease were cancelled and Williams were to undertake to sell the subject gas, Williams would simply assume the obligations of Pennzoil and Shell to continue service to United," unless the Commission authorized abandonment (App. D, *infra*, p. 24a).

6). Inasmuch as Commission rate regulation is cost-based, the court held that the Commission had erred in determining that it was not permitted to pass through to interstate customers the cost to lessee/producers of market value royalty payments. The court relied on *Mobil Oil Corp.* v. *Federal Power Commission, supra,* for the proposition that producers are entitled to special relief from the Commission if their royalty payments are higher than those provided for by the applicable area or natural rate established by the Commission (*id.* at 7).

On the issue of alternative relief, the court directed the Commission to reconsider its decision not to permit abandonment of the royalty portion of the gas. Relying on its decision in *Southland Royalty Co.* v. *Federal Power Commission*, 543 F. 2d 1134 (C.A. 5), certiorari granted, June 27, 1977, *Federal Power Commission* v. *Southland Royalty Co.*, No. 76-1587, the court held that the Commission had been mistaken in concluding that the gas, having once been dedicated to interstate commerce, could not be withdrawn from that service by the lessor without abandonment authorization in the event that the leases were terminated for failure to pay royalties based on the unregulated market price.[4]

[4] On the Commission's limited petition for rehearing, the court deleted from its opinion the final statement that "[i]t may well be that the 'present or future public convenience or necessity' will suggest the propriety of abandoning a fraction of the gas in Williams' property, rather than lose the entire amount from the interstate market. This decision is for the Commission." (App. C, *infra*, pp. 12a-13a). In its opinion on rehearing the court stated "[w]e agree with the Commission that the statement was premature, if construed to be decisional, and unnecessary with respect to our decision" (*id.* at 13a).

REASONS FOR GRANTING THE WRIT

This case presents two issues of substantial importance to the administration of the Natural Gas Act, 52 Stat. 821, as amended, 15 U.S.C. 717 *et seq.*: first, whether the Commission has authority to permit a producer to pass through to interstate customers royalty costs based on the unregulated market price of gas; and second, whether the Commission, in lieu of passing through such costs, may permit a producer to abandon a portion of his gas from dedicated interstate service. The ruling of the court of appeals that the Commission has authority to grant both types of relief will, unless overturned, allow the rate set by the Commission for sales of natural gas for resale in interstate commerce to be based to a significant extent on the unregulated rate prevailing in the market for intrastate sales. It will thus substantially undercut the Commission's effective regulation of interstate sales pursuant to the authority recognized by this Court in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672.[5]

[5] While it might be argued that the effect of the decision below is limited because the court of appeals held only that the Commission had authority to grant the requested relief, not that it was compelled to grant such relief, the court's holding and rationale indicate otherwise. The decision below rejected the Commission's view that the grant of relief would

The two issues presented here are among a number of related issues that all derive from the widespread use in gas leases of clauses that require the producer to pay royalties to the lessor based on the "market value" or "market price" of the gas sold. The first issue presented by such clauses is whether "market value" clauses refers to the regulated interstate market price at which the gas is actually sold, or the unregulated intrastate price which, in recent years, has been substantially higher than the interstate price.[6]

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be inconsistent with the regulatory scheme of the Act; it thus forecloses the Commission from denying relief on that ground. The decision would limit the Commission to reviewing the circumstances of each case to determine whether particular royalty costs were or were not permissible for other reasons—for example, whether they were imprudently incurred. The Commission would be precluded from denying relief on the ground that use of unregulated market prices as a basis for determining a significant component of the regulated rate would undermine the basic purpose of the Act.

[6] In *Lightcap* v. *Mobil Oil*, 221 Kan. 448, 562 P.2d 1, certiorari denied, October 3, 1977, No. 76-1694, the Supreme Court of Kansas construed certain "market value" royalty provisions involved in that case to mean the unregulated intrastate market, and required the producers to pay royalties on that basis. In *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F. 2d 256, 265 (C.A. D.C.), certiorari denied, 406 U.S. 976, however, the court suggested that such a construction not only might "run counter to the intention of the parties, unless there is something to rebut the fair presumption that they contemplated interstate movement and market prices compatible therewith," but also might contravene public policy if not the Supremacy Clause. Although this Court denied certiorari in *Lightcap*, the petitioner has filed a petition for rehearing, and the Commission intends to file a memorandum in support of that petition in view of the relationship between the issue there and the issues presented in this case.

A second issue is whether the Commission has jurisdiction over royalty agreements.[7] A third issue, presented in this case, is whether, if "market value" royalty provisions refer to the intrastate market, the Commission has the authority to include the higher royalty in the producer's cost basis, and thus pass through the higher costs to interstate consumers. A fourth issue, also presented in this case, is whether the Commission alternatively may permit a producer to pay royalties in the form of gas that the lessor may then sell on the intrastate market, and thus abandon a portion of his gas from dedicated interstate service.

While this petition addresses the issues presented in this case, those issues cannot be considered in isolation from the other issues that are different facets of the same problem.

1. The decision below that the Commission may permit producers to base their interstate prices on royalty costs that are in turn based on the unregulated intrastate market value of natural gas is, we

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[7] In *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F. 2d 256 (C.A. D.C.), certiorari denied, 406 U.S. 976, the court of appeals, reversing the Commission, concluded that royalty owners were not "natural gas companies" subject to Commission jurisdiction under the Act. The court did not appear to view its decision as having a decisive impact on royalty levels, however, since it apparently believed that the presumed intention of the parties to gas leases, as well as considerations of public policy and federal regulation, would lead courts to construe "market value" clauses to mean the regulated market at which the gas was actually sold and expected to be sold. See note 6, *supra*.

submit, contrary to decisions of this Court. In *Federal Power Commission* v. *Texaco Inc.*, 417 U.S. 380, this Court reaffirmed the well-established principle that the Commission's responsibility under the Natural Gas Act is to establish interstate rates at levels that are "just and reasonable" (15 U.S.C. 717c, 717d(a)), and that this responsibility is not met by establishing an interstate rate that is based solely on the unregulated marketplace. In that case the Court rejected a Commission rate order that sought to regulate the rates of small producers indirectly through the Commission's regulation of the rates of large producers and of pipelines who purchased gas from the small producers and whose cost of service was therefore based in part on the prices paid to small producers. Since the order appeared to permit the large producers and pipelines automatically to pass through prices paid to the small producers that were based on the prevailing unregulated market, the Court rejected it, stating (417 U.S. at 397-399):

> [W]e * * * stress that in our view the prevailing price in the marketplace cannot be the final measure of "just and reasonable" rates mandated by the Act. It is abundantly clear from the history of the Act and from the events that prompted its adoption that Congress considered that the natural gas industry was heavily concentrated and that monopolistic forces were distorting the market price for natural gas. * * * In subjecting producers to regulation because of anti-competitive conditions in the industry, Congress could not have assumed that "just and reasonable" rates could conclusively be determined by references to market price [footnote omitted].

See also *Federal Power Commission* v. *Sunray DX Oil Co.*, 391 U.S. 9, 25.

The same principles apply here. It is evident that for the Commission to permit a producer to base his interstate rate on royalty costs based on the intrastate market price would result in interstate rates which are in significant part "conclusively * * * determined by reference to market price."[8]

The court of appeals stated that *Texaco* was "inapplicable" to this case, but gave little indication of its reasons for that conclusion (App. A, *infra*, p. 6a). As *Texaco* itself indicates, the fact that royalty costs are one of several components of the producers' cost is immaterial; they are a significant component, and the principles affirmed in *Texaco* do not suggest that the Commission can determine a part of the interstate rate that it promulgates solely on the basis of the unregulated market so long as it does not determine the whole rate on that basis. The Act does not permit the Commission to depart from its obligation to establish just and reasonable rates up to a point, so long as it adheres to that standard the rest of the

[8] Contrary to the court of appeals' view (App. A, *infra*, p. 7a), royalty costs that are based on the intrastate market price of gas are different from other costs (*e.g.*, drilling costs), because allowing a producer to pass such royalty costs through to interstate customers results in a price for interstate gas that is based in part on the unregulated market price of gas, contrary to the principles established in *Texaco* and other decisions.

way.[9] As the Court said in *Texaco, supra*, 417 U.S. at 399, "the Act makes unlawful all rates which are not just and reasonable, and does not say a little unlawfulness is permitted."

2. The Commission's decision in this case is not inconsistent with *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283, relied on by the court below (App. A, *infra*, p. 7a). The Court in *Mobil* upheld an area rate promulgated by the Commission. In response to Mobil's objection that the Commission had failed to provide for automatic rate adjustments to accommodate anticipated increased royalty costs, the Court observed that "Mobil's argument is hypothetical at this stage and * * * in any event an affected producer is entitled to seek individualized relief." 417 U.S. at 328. In making that observation, the Court did not discuss or purport to determine the entitlement to relief under all circumstances, or to decide in particular whether a producer would be

[9] Moreover, in practice, as in this case, the Commission is usually required to discharge its responsibilities under the Act by determining the justness and reasonableness of particular cost components presented to it for consideration. Accordingly, in this case the Commission stated (App. D, *infra*, p. 22a):

> [W]e cannot permit any incremental royalty costs * * * to be passed on to the pipeline if these incremental royalty costs are based on any other factors than the regulated just and reasonable rate.

The Commission's conclusion was not incorrect simply because other cost components of the producers' rate were just and reasonable.

entitled to a rate increase to reflect royalty costs based on the unregulated market.

This Court in *Mobil* merely recognized that the Commission may grant special relief in some instances where actual costs are higher than those provided for in the regulated rate. It does not follow that the Commission may permit royalty payments based on the unregulated price of the very commodity that is subject to federal regulation—natural gas—to be borne ultimately by the consumers of gas sold in interstate commerce. If royalty costs determined by the unregulated price of gas sold in intrastate commerce were passed on to the interstate consumer, a different category of interstate gas would be created, the price for which would be determined in substantial part by intrastate market values and would fluctuate with those values. As recognized in *Texaco*, this would be no regulation at all.

3. The court below also erred in concluding that the Commission had authority under the Act to permit the producer, in lieu of passing through increased royalty costs to its interstate customers, to pay its lessors royalties in the form of gas which they could sell on the intrastate market, thus abandoning that gas from the interstate service to which it had been dedicated. As the Commission correctly found, neither of the two conditions for abandonment under Section 7(b) of the Act, as amended, 15 U.S.C. 717f(b), had been met. First, the available supply of gas had not been "depleted to the extent that continuation of service is unwarranted." Second, there was no basis for

finding that "the present or future public convenience and necessity permit such abandonment." The standard by its terms refers to the *public* convenience and necessity; it does not justify abandonment simply to serve the financial interests of royalty owners or producers.[10]

4. If, as we contend, the Commission may not under the Natural Gas Act permit producers to pass through royalty costs based on unregulated market prices, or alternatively to abandon a portion of their gas, we recognize the possibility—which concerned the court below (App. A, *infra*, p. 8a)—that producers might be caught between state court decisions that "market value" leases refer to the unregulated market and the Commission's refusal to pass through such market value royalty costs or permit abandonment of dedicated gas.[11] While we believe that in any event

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[10] Moreover, the Commission concluded that there was no basis for permitting abandonment of a portion of the gas through payment in kind to avoid abandonment of all of it in the event the lessors terminated the leases since under the Commissions decisions, a lessor may not terminate certified interstate service commenced by his lessee without abandonment authority from the Commission under Section 7(b). The validity of those decisions is now pending before this Court in *Federal Power Commission* v. *Southland Royalty Co.*, No. 76-1587, certiorari granted, June 27, 1977, and this aspect of the instant case should at least await resolution of that case.

[11] As yet there has been no state court ruling in this case on the meaning of the royalty clauses in the leases involved; the parties by their settlement pretermitted that question pending the outcome of this proceeding. As the Commission recognized, however (App. D, *infra*, p. 22a), "the impetus of the settlement" was the unregulated market price of gas.

the Commission's position is mandated by the Act and the Act's purpose to protect interstate consumers of gas, it should be noted that there are possible avenues of relief for producers faced with demands from lessors that their royalty costs be based on the unregulated price of natural gas.

One type of relief could be this Court's limited reshaping of the holding by the court of appeals in *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F. 2d 256 (C.A. D.C.), certiorari denied, 406 U.S. 976, that landowner/lessors are not natural gas companies under the Act and that accordingly neither they nor their royalty agreements are subject to Commission jurisdiction. Such a reshaping would not necessarily require a determination that landowner/lessors are fully jurisdictional in the sense, for example, of being required to make filings with the Commission. Rather, it would be sufficient for this Court to determine that despite the nonjurisdictional status of landowner/lessors, royalty payments are nevertheless subject to regulation in the sense that producer/lessees need not pay royalties which exceed the amounts permitted by the Commission to be passed on to jurisdictional pipelines.

Such a determination, we submit, would be consistent with this Court's recognition that when Congress passed the Natural Gas Act, it "did not desire * * * that an important aspect of this field be left unregulated," but intended instead to establish a comprehensive regulatory scheme. *Federal Power Commission* v. *Transcontinental Gas Pipe Line Corp.*, 365

U.S. 1, 19. The Act "was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378, 388. See also *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, where this Court, reversing the Commission, held that the Commission had jurisdiction not only over pipelines and their rates but also over the rates at which producers sell natural gas to pipelines for resale in interstate commerce, on the ground that those rates "may have a direct and substantial effect on the price paid by the ultimate consumers." 347 U.S. at 685.

An alternative, though related, type of relief for producers would be a determination by this Court that lower courts err when they interpret "market value" leases that underlie interstate sales as requiring royalty payments based on the intrastate market price of the gas. One such state court determination was the basis of a petition for a writ of certiorari to the Kansas Supreme Court, *Mobil Oil Corp.* v. *Harry Lightcap, et al.*, No. 76-1694. Although this Court denied certiorari in that case on October 3, 1977, we are advised that the petitioner on October 28, 1977, filed a petition for rehearing of the decision denying certiorari. As noted (note 6, *supra*), the Commission intends to file a memorandum in support of that petition for rehearing. In view of the relationship between that issue and the other issues discussed in this petition, we believe that the construction of a "market value" lease provision is not solely a question of state law, but is a question of federal law

under the Natural Gas Act. Our belief rests on the principle that "[t]he federal regulatory scheme leaves no room either for direct state regulation of the prices of interstate wholesales of natural gas * * * or for state regulations which would indirectly achieve the same result." *Northern Natural Gas Co.* v. *State Corporation Commission of Kansas*, 372 U.S. 84, 91; footnote omitted. A decision by this Court that market value leases underlying interstate sales must be interpreted in light of the regulated rate of those sales would obviate any bind on producer/lessees between royalties based on intrastate prices and the impermissibility of the Commission's allowing the flow-through of such market value royalty costs.

5. It is axiomatic that the Natural Gas Act, like other federal regulatory legislation, should be interpreted in furtherance of the Act's general purpose to protect consumers by effective regulation of natural gas wholesale rates. Cf. *Securities and Exchange Commission* v. *Ralston Purina Co.*, 346 U.S. 119; *United States* v. *Southwestern Cable Co.*, 392 U.S. 157; *United States* v. *Bacto-Unidisk*, 394 U.S. 784. The Commission, accordingly, concluded that it is not permitted to pass through market value royalty payments that are based on the unregulated price of natural gas or to permit abandonment of gas dedicated for interstate service solely to accommodate the financial interests of private parties. The contrary holding of the court of appeals would significantly impair the Commission's ability to implement one of the Act's basic objectives, and therefore warrants review by this Court.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted.

WADE H. MCCREE, JR.,
Solicitor General.

RICHARD A. ALLEN,
Assistant to the Solicitor General.

ROBERT R. NORDHAUS,
General Counsel,

PHILIP R. TELLEEN,
Attorney,
Federal Energy Regulatory Commission.

NOVEMBER 1977.

APPENDIX A

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

Nos. 76-1626, 76-1831 and 76-2128

PENNZOIL PRODUCING COMPANY, SHELL OIL COMPANY, UNITED GAS PIPE LINE COMPANY, PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT

June 6, 1977

Petitions for Review of an Order of Federal Power Commission (Texas Cases).

Before CLARK, RONEY and TJOFLAT, Circuit Judges.

RONEY, Circuit Judge:

Caught in the squeeze between the regulated price of its gas, which price included royalty costs at the interstate price, and the claims of landowners for increased royalty payments based on higher intrastate rates, the gas producers petitioned the Federal Power Commission for relief. Two alternatives were given the Commission: *first,* let the producers' interstate price be increased by the amount of increased royalty the producers will have to pay as determined by state litigation or settlement of pending lawsuits; or, *second,* let the producers "abandon" the royalty

portion of gas produced so that gas can be delivered to the royalty owner in kind, unburdened by the restrictive interstate price.

As to the first alternative, the Federal Power Commission failed to realize it had the authority to grant relief. As to the second, the Federal Power Commission misunderstood the law as it has now been defined in *Southland Royalty Co.* v. *FPC*, 543 F.2d 1134 (5 Cir. 1976). We reverse and remand for further consideration.

Due to the gross disparity between the higher unregulated prices of intrastate gas sales and the lower regulated prices of interstate sales,[1] lessors, whose royalty payments are determined by the "market value" or the "market price" of the gas, have brought numerous suits against the interstate producers-lessees claiming royalty payments based on rates higher than those prescribed by the Federal Power Commission.[2] Many of these long-term leases were entered into long before this disparity in prices arose, and some even before the Commission began regulating rates for interstate gas sales.[3] Thus, neither lessor

[1] *See Southland Royalty Co.* v. *FPC*, 543 F.2d 1134 (5th Cir. 1976).

[2] *See, e.g., Phillips Petroleum Co.* v. *Bynum*, 155 F.2d 196 (5th Cir.), *cert. denied*, 329 U.S. 714, 67 S.Ct. 44, 91 L.Ed. 620 (1946); *Foster* v. *Atlantic Refining Co.*, 329 F.2d 485 (5th Cir. 1964); *Texas Oil & Gas Corp.* v. *Vela*, 429 S.W.2d 866 (Tex. 1968).

[3] Pennzoil Producing Company and Shell Oil Company sell in interstate commerce natural gas produced from Louisiana acreage leased from Williams, Inc. Pennzoil operates under a

nor lessee anticipated the problem that would arise over the nondefined terms in the leases: "market value" and "market price."

In a lawsuit filed on May 24, 1974, and currently pending in Louisiana state court,[4] a lessor asserted a royalty claim based on intrastate prices for natural gas, which greatly exceed the ceiling rates established by the FPC for interstate sales. After Williams, Inc. demanded by letter payment of royalties based on intrastate rates, Shell and Pennzoil brought the lawsuit seeking a judgment declaring that their royalty obligations were properly discharged by payments based on Commission-established rates. Williams counterclaimed for underpayment of royalty obligations in the amount of $3,731,783.79. On June 18, 1975, Shell, Pennzoil and Williams entered into a settlement agreement providing two major alternatives—one involving monetary payments, and the other involving payments of gas in kind—either being dependent on FPC authorization.

The first alternative provided that the payment of royalties would be based on the higher of the following prices: (1) 78¢ for Mcf for 1975 with annual

1934 lease, while Shell operates under a 1[illegible] and a 1952 lease. The 1934 lease provides for royalty payments equal to one-eighth of the value of the gas produced, calculated at the "market rate" prevailing at the well. The 1952 lease contains a similar provision, requiring royalty payments equal to one-fourth of the value of the gas produced, calculated at the "market price" prevailing at the well.

[4] *Shell Oil Co. & Pennzoil Producing Co.* v. *Williams, Inc., et al.*, Docket No. 573-581, Civ.D.Ct., Orleans Parish, La.

increases of 1.5¢ per Mcf; or (2) 150% of the highest area or national rate permitted by the FPC. Pennzoil and Shell would then flow through these incremental royalty costs to their customer, United Gas Pipe Line Company. Although the FPC does not have jurisdiction over the amount paid royalty owners, *Mobil Oil Corp.* v. *FPC*, 149 U.S.App.D.C. 310, 463 F.2d 256 (1971), *cert. denied*, 406 U.S. 976, 92 S.Ct. 2409, 32 L.Ed.2d 676 (1972), it does have authority over interstate rates charged by the producers. *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 74 S.Ct. 794, 98 L.Ed. 1035 (1954); section 4 of Natural Gas Act, 15 U.S.C.A. § 717c. Thus, special relief from the ceiling rates established in FPC Opinion Nos. 598 [5] and 699 [6] is required for petitioners to pass these costs on to United.

The second alternative provided that in lieu of the increased monetary royalty payments, Shell and Pennzoil would deliver to Williams its royalty share of the gas in kind for sale in any market, which presumably would bring the higher intrastate prices. This second proposal would require the FPC's consent to the

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[5] *Southern Louisiana Area Rate Proceeding*, 46 FPC 86 (1971), *aff'd sub nom., Placid Oil Co.* v. *FPC*, 483 F.2d 880 (5th Cir. 1973), *aff'd sub nom., Mobil Oil Corp.* v. *FPC*, 417 U.S. 283, 94 S.Ct. 2328, 41 L.Ed.2d 72 (1974).

[6] Just and Reasonable National Rates for Sales of Natural Gas From Wells Commenced on or after January 1, 1973, and New Dedications to Interstate Commerce on or after January 1, 1973, 51 FPC 2212, *aff'd sub nom., Shell Oil Co.* v. *FPC*, 520 F.2d 1061 (5th Cir. 1975), *cert. denied*, 426 U.S. 941, 96 S.Ct. 2661, 49 L.Ed.2d 394 (1976).

abandonment of that portion of gas attributable to Williams' royalty interests, as required by section 7(b) of the Natural Gas Act, 15 U.S.C.A. § 717f. *Sunray Mid-Continent Oil Co.* v. *FPC*, 364 U.S. 137, 153, 80 S.Ct. 1392, 4 L.Ed.2d 1623 (1960).

In FPC Opinion Nos. 753 [7] and 753-A,[8] the Commission denied either form of relief. *First*, the Commission denied it had authority to allow producers of natural gas to increase their rates above the FPC ceiling set for gas sold in interstate commerce to reflect the increased cost of "market value" or "market price" royalty obligations under existing leases. *Second*, the Commission held that "present or future public convenience or necessity" did not permit the abandonment of the royalty portion of the gas, which had been dedicated to interstate commerce by the lessees. Section 7(b) of Natural Gas Act, 15 U.S.C.A. § 717f (b). The petitions for review attack both of these decisions.

Opinion 753 defined the "real issue" in this case to be whether the FPC "can legally grant any form of rate relief above either an area or nationwide just and reasonable rate solely because the producer selling the gas in interstate commerce *may* be obligated to make a royalty payment based not upon the regulated price the producer receives for the gas, but rather on the 'market value' of the gas." Relying on

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[7] Opinion and Order Denying Special Relief and Abandonment, FPC Docket Nos. RI 76-8, -10 (January 30, 1976).

[8] Opinion and Order Denying Rehearing, FPC Docket Nos. RI 76-8, -10 (February 27, 1976).

FPC v. *Texaco, Inc.*, 417 U.S. 380, 94 S.Ct. 2315, 41 L.Ed.2d 141 (1974), the Commission concluded that it was "not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates."

Texaco, however, is inapplicable to the instant case. *Texaco* dealt with the question of the effect of *intrastate* prices of gas on *interstate* rate regulation. The Supreme Court held that the final measure of "just and reasonable" rates, mandated by sections 4 and 5 of the Act, could not be the prevailing price in the unregulated marketplace. Prompting this holding was the historical justification for general regulation of interstate prices, to prevent excessive profiteering by members of the heavily concentrated and monopolistic natural gas industry through distorted market prices. 417 U.S. at 397-398, 94 S.Ct. 2315. Thus, the Supreme Court held that other factors must be taken into consideration. 417 U.S. at 399, 94 S.Ct. 2315. This case deals with royalty cost under specific leases.

The Federal Power Commission has taken a cost plus profit approach to gas rate regulation. A cost-based methodology was approved by the Supreme Court in *Permian Basin Area Rate Cases*, 390 U.S. 747, 88 S.Ct. 1344, 20 L.Ed.2d 312 (1968). One of the components of a producer's costs is clearly its royalty expense, representing the amount a producer must pay to the landowner for the privilege of extracting gas from the reserves underlying his land. *Shell Oil Co.* v. *FPC*, 520 F.2d 1061, 1068 (5th Cir. 1975), *cert. denied*, 426 U.S. 941, 96 S.Ct. 2661, 49 L.Ed.2d 394

(1976). This cost petitioners seek to pass through to their customer, United, through a rate increase. They do not seek to increase their profits but merely to maintain those margins already determined by the Commission to be just and reasonable in its earlier rate proceedings. Because the Commission does not have jurisdiction over the amount of royalties charged by the lessor under a natural gas lease, *Mobil Oil Corp.* v. *FPC*, 149 U.S.App.D.C. 310, 463 F.2d 256, 263, *cert. denied*, 406 U.S. 976, 92 S.Ct. 2409, 32 L.Ed.2d 676 (1972), the only way in which petitioners-lessees can protect themselves from loss of profits in the event of an adverse state court decision is to ask for an increase in the allowable rates to be charged their customers.

This is not to say that every additional cost must be passed through to the customer to protect a producer's level of profits. The Commission has authority to consider the reasonableness of any costs incurred. *Mobil Oil Corp.* v. *FPC*, *supra*, at 263. Determination of the reasonableness of a cost necessarily requires consideration of market price. In all probability, the reasonableness of a great many costs of gas production must be determined by the prevailing market price in an uncontrolled market. The Commission has failed to suggest why royalty costs in an uncontrolled market are any different from any other cost. *Permian* and *Shell Oil* should have been looked to for guidance by the Commission, rather than *Texaco*.

Petitioners followed the proper procedures in petitioning the Commission for special relief and were entitled to a determination of the merits of their requests. In *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283, 94 S.Ct. 2328, 41 L.Ed.2d 72 (1974), *aff'd Placid Oil Co.* v. *FPC*, 483 F.2d 880 (5th Cir. 1973), decided the same day as *Texaco*, the Supreme Court, in response to Mobil's complaint that the FPC failed to provide automatic adjustments in area rates to compensate for anticipated higher royalty costs, reiterated the Court of Appeals' finding that " '[i]f, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief.' " 417 U.S. at 328, 94 S.Ct. at 2355. Pennzoil and Shell have been put in such a bind. If they lose the state court litigation, they are faced either with termination of their leases, which could divert the entire amount of gas from interstate commerce, or with increased royalty payments, which would absorb funds otherwise available for exploration and development.

In denying abandonment of the royalty portion of the gas, which is allowed under section 7(b) of the Natural Gas Act only when "the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted," or when "the present or future public convenience or necessity permit such abandonment", the Commission relied on its decision in *El Paso Natural Gas Co., et al.*, FPC Opinion No. 737 (July 11, 1975), *appeal then pending sub nom., Southland Royalty Co.* v. *FPC*, 5 Cir., 543 F.2d

1134 (1976). The Federal Power Commission held in *El Paso* that once a fixed-term lessee dedicates gas to interstate commerce, the lessor cannot withdraw that gas from interstate commerce absent Commission approval, upon termination of the lease. Thus the Commission was under the impression that Williams' gas was trapped in the interstate market, whether or not the leases were terminated.

This Court reversed the Commission's decision in *Southland Royalty Co.* v. *FPC*, *supra*, and held that a lessee could not dedicate to interstate commerce the gas remaining at the expiration of his fixed-term lease. Thus the Commission was acting under the wrong legal premise. It is appropriate to remand this issue to the Commission for reconsideration in light of *Southland Royalty*. It may well be that the "present or future public convenience or necessity" will suggest the propriety of abandoning a fraction of the gas in Williams' property, rather than lose the entire amount from the interstate market. This decision is for the Commission.

REVERSED AND REMANDED.

APPENDIX B

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

OCTOBER TERM, 1976

76-1626
Nos. 76-1831
76-2128

FPC Nos. RI76-8 and RI76-10

PENNZOIL PRODUCING COMPANY, ET AL., PETITIONERS

versus

FEDERAL POWER COMMISSION, RESPONDENT

Petitions for Review of an Order of the
Federal Power Commission (Texas Cases)

Before CLARK, RONEY and TJOFLAT, Circuit Judges.

JUDGMENT

This cause came on to be heard on the petitions of Pennzoil Producing Company, Shell Oil Company and United Gas Pipe Line Company for review of an order of the Federal Power Commission of the United States, and was argued by counsel:

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the order of the Federal Power Commission in this cause be, and the same is hereby reversed: and that this cause be, and the same is hereby remanded to the Federal Power Commission in accordance with the opinion of this Court.

June 6, 1977

APPENDIX C

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

Nos. 76-1626, 76-1831, 76-2128

PENNZOIL PRODUCING COMPANY, ET AL., PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT

Sept. 1, 1977

Petitions for Review of an Order of Federal Power Commission (Texas Cases).

ON PETITION FOR REHEARING

(Opinion June 6, 1977, 5 Cir., 1977, 553 F.2d 485)

Before CLARK, RONEY and TJOFLAT, Circuit Judges.

PER CURIAM:

In its petition for rehearing, the Federal Power Commission asserts that language in the opinion may erroneously indicate the prejudgment of an issue not before the Court, *i.e.*, the effect of our decision in *Southland Royalty Co.* v. *FPC*, 543 F.2d 1134 (5th Cir. 1976) on a state court termination of a lease, particularly one not limited by a fixed-term.

In order to pull from the opinion any indication as to how *Southland* might apply to the facts of this case, we delete from our opinion the last two sentences found at the end of the final paragraph, which read as follows:

> It may well be that the "present or future public convenience or necessity" will suggest the propriety of abandoning a fraction of the gas in Williams' property, rather than lose the entire amount from the interstate market. This decision is for the Commission.

We agree with the Commission that the statement was premature, if constructed to be decisional, and unnecessary with respect to our decision.

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby DENIED.

APPENDIX D

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Richard L. Dunham, Chairman; Don S. Smith, John H. Holloman III, and James G. Watt.

Docket No. RI76-8
Docket No. RI76-10

PENNZOIL PRODUCING COMPANY
SHELL OIL COMPANY

OPINION NO. 753

OPINION AND ORDER
DENYING SPECIAL RELIEF
AND ABANDONMENT

(Issued January 30, 1976)

Pennzoil Producing Company (Pennzoil) on July 1, 1975, and Shell Oil Company (Shell) on July 18, 1975, filed applications seeking special relief from the just and reasonable rates [1] established under Opinion

[1] Sections 4(a) and 5(a) of the Natural Gas Act, require that all rates received by a "natural gas company" be "just and reasonable". 52 Stat. 822, 823 (1938); 15 U.S.C. §§ 717c(a), 717d(a) (1970).

See, e.g., FPC v. *Texaco Inc.*, 417 U.S. 380 (1974).

Nos. 598 [2] and 699 [3] in order to flow through to their customer, United Gas Pipe Line Company (United), higher royalty rates called for in a settlement agreement dated June 18, 1975, with their lessors, Williams, Inc. and others (Williams).

The gas involved is produced in the Gibson Field, Terrebonne Parish, Louisiana, from leases with Williams dated August 29, 1934, and July 24, 1952. The 1934 lease provides for payment of a royalty equal to one eighth (1/8) of the value of the gas produced calculated at the "market rate" prevailing at the well. The 1952 lease provided for a royalty of one-fourth of the value of the gas calculated at the "market price" prevailing at the well. By letters dated June 7, 1973, and March 27, 1974, Williams demanded payment by Shell and Pennzoil of royalties based on market values ranging from 35 cents to 70 cents per Mcf for the period October 1, 1971, through December 31, 1973, and 70 cents per Mcf thereafter. By letter of June 5, 1974, Williams purported to terminate the leases (Exhibit No. 3).

[2] *Area Rate Proceeding et al. (Southern Louisiana Area)*, 46 FPC 86 (1971), *aff'd sub nom. Placid Oil Co.* v. *FPC*, 483 F.2d 880 (5th Cir. 1973); *aff'd sub nom. Mobil Oil Corp.* v. *FPC* 417 U.S. 283 (1974).

[3] *Just And Reasonable National Rates For Sales Of Natural Gas From Wells Commenced On Or After January 1, 1973, And New Dedications To Interstate Commerce On Or After January 1, 1973*, Docket No. R-389-B, Opinion No. 699, 51 F.P.C. 2212 (June 21, 1974), *reh. denied*, Opinion No. 699-H, 52 F.P.C. —— (December 4, 1974, *aff'd sub nom. Shell Oil Co.* v. *FPC*, 520 F.2d 1061 (5th Cir. 1975).

On May 24, 1974, Shell and Pennzoil filed a petition in the Civil District Court in the Parish of Orleans, Louisiana [4] praying for a Judgment declaring that the petitioner's interpretation of "market rate" and "market price" was correct, that they have properly discharged their royalty obligations on the basis of Commission established rates and that the leases are still in effect (Exhibit No. 4). They also asked for a temporary restraining order, which was granted. Williams filed an answer and reconventional demand (counterclaim), with an amendment alleging market prices for the gas for the period October 1, 1971, to April 30, 1975, ranging from $.35 to $1.40 per Mcf and underpayments of $3,731,683.79 (Exhibit Nos. 5, 6).

In the settlement of June 18, 1975, Pennzoil and Shell would apply to the Commission for authority to pay a royalty based on a price of 78 cents per Mcf for 1975 and 1.5 cents per Mcf more each year or 150 percent of the highest area or national rate permitted, plus Louisiana severance tax, Federal taxes and Btu adjustment. Alternatively, Pennzoil and Shell would ask for authority to deliver to Williams one-eighth or one-fourth, as the case may be, of the gas attributable to their respective interests, and to abandon their sales of this gas to United.

If the Commission approves the price alternative, Pennzoil and Shell would pay a royalty for 1974 equal

[4] *Shell Oil Company and Pennzoil Producing Company* v. *Williams Inc., et al,* Civ.D.Ct. Orleans Parish, La., Docket No. 573-581.

to what would have been paid based on a price of 45 cents per Mcf, but only to the extent the Commission permits them to recover such amounts from United. If the Commission approves the alternative delivery of the gas to Williams, Pennzoil and Shell would pay an additional royalty until the date of a final order.

After the Commission's order becomes final and non-appealable the parties would dismiss their Louisiana civil suit. Pennzoil and Shell are to use their best efforts to obtain the approval of the Commission. If the Commission refuses to do so on or before February 1, 1976, either Williams or Shell and Pennzoil, acting together, may terminate the agreement. In separate agreements United agreed to make the additional payments or to release the royalty gas (Exhibit Nos. 7, 8).

In its order of August 29, 1975, the Commission denied the petitions of Pennzoil and Shell for special relief and prescribed a hearing on the issue relating to the abandonment of the royalty gas. On September 22, 1975, the Commission granted rehearing and provided that the hearing cover the issue of special relief. The hearing was held before Presiding Administrative Law Judge Samuel Z. Gordon on September 23, 1975, at which Shell, Pennzoil and United presented evidence. Shell was afforded additional time to present certain factual data as to prices, volumes and cost and did so on September 29, 1975. The costs it presented were derived from national costs with a figure for operating expenses from the 1934 and 1952

leases substituted for the national figure. Shell was given opportunity to file additional cost data but advised that it did not intend to do so (Exhibit No. 10), although it filed answers to written interrogatories submitted by the Commission staff.

In his initial decision issued November 24, 1975, the Judge denied special relief on the ground that the producer must establish that his overall costs incurred in the operation of the particular well or group of wells are higher than area or nationwide rates, or that his out-of-pocket expenses will exceed revenues. Pennzoil, he said, had made no such showing and Shell had attempted to use the nationwide costs with a 4.5 cents figure for operating costs and a royalty figure based on $1.40 per Mcf market value.

The Judge also determined that Pennzoil and Shell have not established that abandonment of the royalty interest is permitted by the public convenience and necessity. Williams has agreed to accept higher royalty payments computed on the basis of 78 cents per Mcf, he pointed out, and Shell has shown that it could absorb higher royalty costs while Pennzoil has not made a showing that it could not. Furthermore, the abandonment should be denied because William's claim is unadjudicated. He would also deny the requested surcharge for past royalties.

Exceptions were filed by Pennzoil, Shell, United, Mobil Oil Corporation (adopting those of Pennzoil and Shell) and the State of Louisiana, and a brief opposing exceptions was filed by Staff.

Since the filing of the exceptions Pennzoil on January 20, 1976, filed a motion for leave to lodge a document with the Commission and to comment on the Commission's Opinion No. 749 [5] prescribing rates for flowing gas. The document is a letter dated January 5, 1976, from counsel for Williams requesting answers to interrogatories in the Louisiana litigation and stating that Williams intended to reactivate the state proceedings as soon as possible under the settlement agreement. In its comments on Opinion No. 749 Pennzoil says that, as to the old gas, the royalty increment under the settlement would be added to the Opinion No. 749 rate,[6] rather than to the Southern Louisiana Area rate. Pennzoil argues that the Opinion No. 749 rate should apply even though it is granted special relief here [7] because this is not a typical relief case since all increased sums will be passed directly to the lessors. Since we are denying the requested relief as discussed below, it is not necessary to determine this issue.

Pennzoil objects to the Judge requiring project cost evidence, saying that the cost inquiry should be limited to the costs and revenues associated with the price

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[5] ***Just And Reasonable National Rates For Sales Of Natural Gas From Wells Commenced Prior To January 1, 1973***, —— FPC ——, Opinion No. 749, Docket No. R-478, —— F.P.C. —— (December 31, 1975).

[6] The Opinion No. 749 rate is 23.5 cents per Mcf 23.5 cents per Mcf prior to July 1, 1976, and 29.5 cents per Mcf thereafter, subject to adjustments.

[7] *See* Opinion No. 749, at 48-49.

increase. It argues that the risks of the Williams litigation render the current price inappropriate and lease termination is a serious possibility. If Williams wins in the litigation, Pennzoil says, it might be able to sell the gas in intrastate commerce, or it might sell all of the gas under a new contract at 130 percent of the national rate under Section 2.56a(a)(2)(iii) of the Regulations [8] and Opinion No. 742 [9], and for all of the gas this would be 27 cents per Mcf more than Pennzoil is currently collecting. It further contends that market value royalties involve considerations different from those involved in the determination of other items of cost since royalties are flowed-through to the lessor. Finally, it notes that substantial risks are avoided by an increase in average price from 40.91 cents per Mcf to 44.55 cents per Mcf or 3.64 cents, none of which inures to Pennzoil's benefit.

Shell makes similar arguments about the lack of necessity for showing overall costs, saying that proof of overall costs is not required in a special relief case. Likewise Shell argues that failure to approve the settlement risks interstate gas supply and threatens higher prices, and asks the Commission to consider the end result. United urges that the settlement be approved in the public interest as concerned with the certainty of gas supply and reasonable prices. Louisiana argues that the Judge failed to apply proper

[8] 18 C.F.R. § 2.56a(a)(2)(iii).

[9] *Small Producer Regulation*, Docket No. R-393, Opinion No. 742, —— FPC ——.

standards in denying rate relief contending that changed circumstances have made no longer appropriate the royalty cost assumptions that went into the applicable rate structures, and Louisiana supports the settlement as a reasonable and appropriate resolution of the issues. On the other hand the staff argues against reliance on non-cost factors and Shell's use of national cost figures, which it points out are only averages.

PRICE RELIEF

The real issue in this proceeding is whether the Federal Power Commission can legally grant any form of rate relief above either an area or nationwide just and reasonable rate solely because the producer selling the gas in interstate commerce *may* be obligated to make a royalty payment based not upon the regulated price the producer receives for the gas, but rather on the "market value" of the gas. Moreover, as in this proceeding, the question becomes somewhat speculative because of litigation between producer lessees and lessors over the extent of such royalty obligations.

While sympathetic to the plight of the producers who face or may face litigation on the value of royalties, we today must find that such producers are not entitled to rate relief. While we admittedly do not have jurisdiction over royalty owners as such [10] and, therefore, over royalty payments by producers to

[10] See *Mobil Oil Corporation* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1972).

lease owners, we do have jurisdiction over the rates charged by producers to the pipelines for sales of gas for resale in interstate commerce and those rates must be "just and reasonable".[11] Hence, if a producer desires to compute royalty payments based on a rate in excess of our applicable just and reasonable rate, he may unilaterally do so. However, if a producer attempts to flow this cost through to the pipeline and ultimately to the consumer, we must determine if this *incremental royalty cost* is just and reasonable. Yet, in making this finding, it would be inconsistent and contrary to the Commission's mandate to establish a just and reasonable rate and at the same time allow a producer selling at that just and reasonable rate to increase this rate for additional royalty payments which are based on other factors than the regulated rate.

In the instant proceeding, the impetus of the settlement is the market value of the royalties and no consideration has been given to regulated rates. As such, we cannot permit any incremental royalty costs resulting from this settlement, or resulting from any judgment by a state court regarding royalty payments, to be passed on to the pipeline if these incremental royalty costs are based on any other factors than the regulated just and reasonable rate. On this point, we note the Supreme Court's warning in *FPC* v. *Texaco, supra*, that the Commission is not free to

[11] See *Mobil Oil Corporation v. FPC, et al.*, 417 U.S. 283 (1974); *FPC* v. *Texaco, Inc.*, 417 U.S. 380 (1974).

equate just and reasonable rates with the prices for gas in the marketplace. Accordingly, we believe that we are not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates. A contrary result would not ". . . afford consumers a complete, permanent, and effective bond of protection from excessive rates and charges." [12]

ABANDONMENT

Pennzoil argues that abandonment of the royalty portion of the gas should be allowed under Section 7(b) of the Natural Gas Act[13] as in the public convenience and necessity if price relief is not granted. Pennzoil says the choice here is between losing one-eighth of the gas and risking the loss of all of the gas. While United prefers the requests for increased rates, it says the Commission should approve the

[12] See *Atlantic Refining Company* v. *Public Service Commission of the State of New York,* 360 U.S. 378, 388 (1959).

[13] Section 7(b) provides:

> No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

52 Stat. 824 (1938); 15 U.S.C. § 717f(b) (1970).

requests to abandon the royalty portion of the gas if price relief is denied.

We find no reason to grant abandonment on the basis of this record. There is no showing "that the available supply of natural gas is depleted to the extent that the continuation of service is unwarranted, or that the present or future public convenience or necessity" requires that abandonment be authorized.

The supply of natural gas involved in this case is not depleted so abandonment may not be approved for that reason. Moreover, the public convenience and necessity, present or future, is not served by granting an abandonment authorization that would likely result in the subject gas being diverted from the interstate market to the intrastate market.

Since "there can be no withdrawal of that supply [of natural gas] from continued interstate movement without Commission approval" [14] once the gas is dedicated, we do not share the concern of Pennzoil and United that Williams could terminate deliveries to United even if the leases were cancelled as a result of state court litigation. If the lease were cancelled and Williams were to undertake to sell the subject gas, Williams would simply assume the obligations of Pennzoil and Shell to continue service to United. *El Paso Natural Gas Company, Texaco Inc.*, Docket Nos. CP75-209, CI75-594, Opinion No. 737, —— F.P.C. —— (July 11, 1975), *rehearing denied*, Opinion No. 737-A, —— F.P.C. —— (September 3, 1975), *rehearing granted* on limited issue, Opinion No. 737-B, —— F.P.C. —— (December 18, 1975), *appeal pending sub nom. Southland Royalty Co.* v. *F.P.C.*, No. 75-2851 (5th Cir.). In such a case, Williams would not be entitled to the status afforded a royalty owner by *Mobil Oil Corp.* v. *F.P.C.*, 463 F.2d 256 (D.C. Cir. 1971), but would be a natural gas company making sales for resale of natural gas in interstate commerce subject to the Commission's jurisdiction. *Phillips Petroleum Company* v. *Wisconsin*, 347 U.S. 672 (1954). We, therefore, deny the alternative requests for abandonment.

[14] *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378, 389 (1959).

SURCHARGE

Pennzoil argues that the surcharge contained in the settlement to pay Williams for alleged past underpayment of royalties was not settled in the Commission's orders, is not a retroactive rate increase, represents less than the full claim and should be allowed. For the reasons set forth above in denying the requested price relief, we also deny the requested surcharge.

The Commission further finds:

The initial decision issued November 24, 1975, in these proceedings denying the applications of Pennzoil and Shell for special relief or abandonment, and a surcharge should be affirmed for the reasons set forth above.

The Commission orders:

(A) The initial decision issued November 24, 1975, in these proceedings is affirmed for the reason set forth above.

(B) The petitions of Pennzoil and Shell requesting special relief or abandonment and a surcharge are denied.

(C) The motion to lodge a document and comment filed on January 20, 1976, is granted.

(D) Exceptions not granted are denied.

By the Commission.

[SEAL]

KENNETH F. PLUMB,
Secretary.

APPENDIX E

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Richard L. Dunham, Chairman; John H. Holloman III, and James G. Watt.

Docket No. RI76-8

PENNZOIL PRODUCING COMPANY

Docket No. RI76-10

SHELL OIL COMPANY

OPINION NO. 753-A

OPINION AND ORDER DENYING REHEARING

(Issued February 27, 1976)

Pennzoil Producing Company and Shell Oil Company on February 13, 1976, and United Gas Pipe Line Company (United) on February 26, 1976, have filed applications for rehearing of the Commission's Opinion No. 753 and order issued January 30, 1976. The Opinion and order relate to gas produced by Pennzoil and Shell in the Gibson Field, Terrebonne Parish, Louisiana and sold to their customer, United Gas Pipe Line Company. The lessors in the Field, Williams, Inc. and others (Williams), had demanded higher royalties based on the market price for the gas;

a civil suit in Louisiana had commenced on the applicability of the market price; and on June 18, 1975, Pennzoil, Shell and Williams had entered into a settlement agreement under which Pennzoil and Shell would apply to the Commission for authority, among other things, to pay a royalty based on a price of 78 cents per Mcf, or alternatively abandon the royalty gas to Williams. Pennzoil and Shell also agreed to pay Williams a surcharge for alleged past underpayment of royalties and proposed to flow through the increased royalties and the surcharge to United.

In its Opinion No. 753 and order the Commission, in adopting the initial decision of the Administrative Law Judge, denied the special relief, the surcharge and the abandonment. Pennzoil and Shell contend that the Commission is in error and, Pennzoil states that, while the settlement agreement was subject to cancellation by February 1, 1976, Williams has agreed that the settlement will not be cancelled before March 1, 1976.

In the first place Pennzoil contends that the Commission has authority to allow increased rates to reflect royalty payments based on prices in excess of ceiling rates. The Commission said that it was not free to allow royalty costs, which are based on market values, to be passed on to the pipeline as just and reasonable rates. Pennzoil cites *Placid Oil Co.* v. *F.P.C.*, 483 F.2d 880 (CA5, 1973), where the Court said that if producers are put in a bind by their royalty obligations they may petition the F.P.C. for individualized relief, and *Mobil Oil Corp.* v. *F.P.C.*,

417 U.S. 283 (1974), affirming *Placid* and saying that a producer affected by higher royalty obligations is entitled to seek individualized relief. While indicating that relief on some grounds may be possible, this case does not state under what conditions relief should be granted, nor does it define when the right to gain relief matures.

In *F.P.C.* v. *Texaco Inc.*, 417 U.S. 380 (1974), the Commission was instructed to insure "that the rates paid by pipelines, and ultimately borne by the consumers, are just and reasonable" and that "the prevailing price in the market place cannot be the final measure of just and reasonable rates mandated by the Act." While Pennzoil argues here that the price increase is based on a number of factors, including the risks of the Williams litigation, the propriety of the settlement, and the fact that it is not based on the full market price, it is plain that the royalty is to be based on 78 cents, which is the settlement's reflection of market prices, that are above the area ceiling prices.

The area ceiling prices are intended to be just and reasonable rates. The Commission was upheld in determining just and reasonable rates for the Southern Louisiana area in *Mobil, supra.* The Commission determined just and reasonable national rates in Opinions Nos. 699 and 699-H and was affirmed on appeal.[1] In arriving at the national rates costs of pro-

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[1] *Just and Reasonable National Rates for Sales of Natural Gas from Wells Commenced on or after January 1, 1973,* Opinion No. 699, 51 FPC 2212 (1974); Opinion No. 699-H, ——

duction were used and royalties were computed at 16 percent of total costs. (51 FPC at pp. 2272-2273) It is for these reasons that the Commission is not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates.

Pennzoil argues that it is an entirely different question when we are dealing with an incremental price that does not generate excessive profits, but *Texaco* says that "a little unlawfulness" is not permitted. In this connection *American Petrofina Company of Texas (Operator), et al.,* —— FPC ——, Docket Nos. RI75-17 and RI75-19, issued March 3, 1975, is not in point. In that case the company was given relief because of the costs of additional necessary compression. There was no question of the reasonableness of compression costs or whether they were determined on the basis of lower interstate prices or higher intrastate prices. Nor are the *El Paso Natural Gas Company,* —— FPC ——, Docket No. RP74-22, *et al.*, orders issued November 29, 1974, and January 29, 1975, in point. In that case the Commission had originally prevented El Paso from collecting a rate increase based on increased royalties which had not yet been paid, but in the cited orders we allowed such rate increases to go into effect subject to refund saying that El Paso had begun paying the increased royalty charges but our review raised a number of issues relating to the justness and reasonableness of

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FPC ——, Docket No. R-389-B, issued December 4, 1974; *aff'd Sub. Nom. Shell Oil Co.* v. *F.P.C.*, 520 F.2d 1061 (CA 5, 1975).

the proposed rates that required further consideration by the Commission. Thus in *El Paso* the validity of the increased charges based on royalties was not determined.

Pennzoil further argues that the price increase is just and reasonable, pointing out the risks of the Williams litigation and contending that the gas may be diverted from the interstate market. Pennzoil also notes that no one has contended that the costs involved were improvidently occurred. These considerations are not controlling. The Commission does not have the power to base a part of the regulated price on the unregulated market value of intrastate gas. Pennzoil also objects to the statement that the Commission cannot permit incremental royalty costs resulting from any judgment by a state court from being passed on to a pipeline if the incremental costs are based on any other factors than the regulated just and reasonable rate. Pennzoil says that this is dicta and it should be eliminated. Since there is no state court judgment and it is indeed dicta, it will not be necessary to discuss it further at this time. Pennzoil's arguments on the issues of abandonment and surcharge are sufficiently covered in the original opinion, and need not be addressed again.

Shell has listed specifications of error that relate to the discussion of the Administrative Law Judge as well as to our discussion in Opinion No. 753. These matters have largely been covered. Shell contends, *inter alia*, that we have not considered the end result of our decision on the consumer, saying that the gas

supply may be lost. The gas supply here that is dedicated to interstate commerce cannot be diverted to intrastate commerce. At the same time, if royalty costs could be based on higher intrastate market values, the impact on the consumer could extend far beyond this case. It is not in the public interest that national rates be distorted in the manner contemplated by Shell, which would create a new species of interstate gas which would rise and fall with intrastate market values.

Also Shell says that the Commission has foreclosed any consideration of the market value royalty problem in any forum and has therefore deprived Shell of its property without due process of law. In this proceeding a hearing was held; the Presiding Judge issued an initial decision to which exceptions were taken; and the Commission considered the issues on the basis of the record. There is no dispute whatever about the facts relating to the computation of the proposed rates based upon market value royalties. Pennzoil, Shell and United have expressed their views, and the Commission determined that special relief should not be granted on the basis of market value royalties. United's contentions are covered by Opinion No. 753 and this Opinion.

The Commission further finds:

The assignments of error and grounds for rehearing of Opinion No. 753 and order in the applications for rehearing filed by Pennzoil, Shell, and United present no facts or legal principles that would warrant any

change in or modification of the Commission's Opinion No. 753 and order as supplemented by the above discussion.

The Commission orders:

The applications for rehearing filed by Pennzoil and Shell on February 13, 1976, and United on February 26, 1976, are denied.

By the Commission.

[SEAL]

KENNETH F. PLUMB,
Secretary.

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Supreme Court, U. S.
FILED
AUG 25 1978
MICHAEL RODAK, JR., CLERK

APPENDIX

In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION, PETITIONER

v.

PENNZOIL PRODUCING COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI FILED November 3, 1977
CERTIORARI GRANTED JUNE 12, 1978

Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION, PETITIONER
v.
PENNZOIL PRODUCING COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

PENNZOIL PRODUCING COMPANY

Docket No. RI 76-8

PENNZOIL PRODUCING COMPANY'S PETITION FOR AUTHORIZATION TO COLLECT INCREASED RATES BASED ON INCREASED ROYALTY PAYMENTS OR, IN THE ALTERNATIVE, TO ABANDON SALES OF ROYALTY VOLUMES, FOR WAIVER OF REGULATIONS, AND FOR EXPEDITION

I.

Pennzoil Producing Company (Pennzoil), pursuant to Sections 4 and 7 of the Natural Gas Act and the Commission's Regulations thereunder, petitions the Commission to:

a. Authorize Pennzoil to charge and collect increased rates to reflect increased royalty payments resulting from settlement of pending litigation regarding gas covered by its FPC Gas Rate Schedule No. 234, or, in the alternative, authorize Pennzoil to abandon the sale of one-eighth (1/8) of such gas, effective January 1, 1974 but in no event later than October 1, 1975;

b. Waive Sections 154.93 and 154.105 of its Regulations and Section 2.56h of its General Policy and Interpretations;

c. Provide a shortened notice period;

d. Provide abbreviated or accelerated procedures, including, if a formal hearing is set, omission of the intermediate decision or setting of a date certain for any intermediate decision.

In support hereof, Pennzoil states as follows:

* * * *

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III

Pennzoil sells gas produced from the Gibson Field, Terrebonne Parish, Louisiana, to United Gas Pipe Line Company (United) under Pennzoil's Rate Schedule No. 234; the sale was certificated in Docket No. G-13633 on May 21, 1965 at which time Pennzoil's gas sales contract was designated as its FPC Gas Rate Schedule No. 75. Upon the execution and filing of a replacement contract, dated October 30, 1959, the Rate Schedule designation was changed to No. 234, as noted in the May 21, 1965 order in Docket No. G-13633. A portion of the gas is produced from acreage covered by a 1934 lease (the 1934 Lease) from F. B. Williams Cypress Company, Limited (now Williams, Inc.) to Shell Petroleum Corporation (now Shell Oil Company); a portion of the acreage was subleased by Shell Oil Company (Shell) to Union Producing Company (Pennzoil's predecessor) by instrument dated December 29, 1942.

The 1934 Lease provides for royalty on the gas production thereunder equal to one-eighth (1/8) "of the value thereof, calculated at the market rate prevailing at the well." The price Pennzoil may collect from United for this gas is regulated by this Commission.

However, by letters dated June 7, 1973 and March 27, 1974, Williams, Inc., *et al.* (Williams) demanded payment of royalty on this gas based upon so-called market values substantially above the price the Commission allows Pennzoil to collect from United and, therefore, above the price on which royalty is computed. In addition, by letter dated June 5, 1974, Williams declared the 1934 Lease terminated because of Pennzoil's alleged failure to pay the royalty which Williams claimed.

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Pennzoil was unable to resolve the matter and, in order to protect its rights and interests, on May 24, 1974, Pennzoil and Shell (against which Williams made similar demand) filed a petition against Williams in the Civil District Court in the Parish of Orleans, Louisiana (*Shell Oil Company and Pennzoil Producing Company* v. *Williams, Inc., et al.*, Dkt. No. 573-591), asking issuance of a judgment declaring that Shell and Pennzoil are paying the appropriate royalty. By reconventional demand, Williams requested the Court to order, *inter alia,* cancellation of the 1934 Lease effective June 5, 1974, an accounting for, and payment of the value of, all minerals produced under the 1934 Lease since June 5, 1974, payment of $1,055,204.62 in "underpaid" royalties for the period through May 31, 1974, and payment of damages and attorneys' fees. The "underpayment" of royalties was calculated on the basis of an increasing market value of gas up to 70¢ per Mcf for the period from November 1973 through May 1974. Subsequently, Williams has amended its reconventional demand to cover the period from June 1, 1974 through April 30, 1975, alleging additional underpayments of royalties by Pennzoil of $1,989,222.91, based on an alleged market value of gas of $1.30 per Mcf from June 1, 1974 through December 31, 1974, and $1.40 per Mcf from January 1, 1975 through April 30, 1975.

IV.

After protracted negotiations, Pennzoil and Williams reached a settlement designed to permit Williams a higher royalty and to permit Pennzoil to retain the leases and sell the gas to United and the interstate market. That agreement is embodied in a document dated June 18, 1975 (the "Settlement Agreement"), a copy of which is attached

hereto as Exhibit A. The Settlement Agreement provides that Pennzoil will request this Commission to approve either:

> 1. Abandonment of the royalty share of the gas to Williams, or
>
> 2. Payment of a negotiated royalty equal to one-eighth (1/8) of the total of (a) the higher of (i) the royalty base rate or (ii) the base alternative rate, (b) 7¢ per Mcf (the current amount of the Louisiana severance tax, and (c) any Btu adjustments for gas containing more or less than 1000 Btu's per cubic foot, and the passthrough of such amount to United.
>
> The base royalty rate is 78¢ per Mcf for 1975 and will increase 1.5¢ per Mcf each January 1 beginning January 1, 1976.
>
> [263]
>
> The base alternative rate is 150% of the highest area or national rate or, in the event of deregulation of gas sales, is the average of the three highest prices in producer sale for resale contracts in the South Louisiana Area.

Pursuant to the Settlement Agreement, Pennzoil requests the Commission to issue its approval effective January 1, 1974.

In addition, the Settlement Agreement defines the "Date of Final Order" as the first day on which a Commission order containing the requested authorization may first be appealed, and provides that the authorized procedure will be implemented on the Date of Final Order. In addition:

> a. If abandonment authorization is granted, any royalty gas not delivered to Williams between the effective date of the Commission's order and the Date of Final Order will be delivered to Williams as soon as practicable, but such "make-up" deliveries must be

completed in not less than one-half of the time between the effective date of the Commission's order and the Date of Final Order.

b. Pennzoil is required within thirty days after the Date of Final Order to remit to Williams the sum of:

(i) the royalty which would have been paid on volumes delivered during 1974 had Pennzoil's sale price been 45¢ per Mcf, less the royalty actually paid, to the extent Pennzoil is allowed to recover such amounts from United, plus

(ii) if the Commission approves Pennzoil's payment of the higher royalty to Williams and recovery thereof from United, the royalty agreed upon for 1975 for volumes delivered during the period beginning on the effective date of the Commission's order (but not earlier than January 1, 1975) or October 1, 1975, whichever occurs first, and ending on the Date of Final Order.

Finally, the Settlement Agreement provides that if the Commission fails to issue acceptable authorization on or before February 1, 1976, either party may terminate the Settlement Agreement.

* * * *

[Text of Settlement Agreement appears both at R.268 and R.293 and is reproduced in this appendix at page 15.]

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

SHELL OIL COMPANY

Docket No. RI76-10

PETITION BY SHELL OIL COMPANY FOR SPECIAL RELIEF AUTHORIZING COLLECTION OF RATES ABOVE APPLICABLE AREA OR NATIONAL RATE LEVELS BASED ON INCREASED ROYALTY PAYMENTS, OR IN THE ALTERNATIVE, TO ABANDON SALES OF ROYALTY VOLUMES, FOR WAIVER OF REGULATIONS, AND FOR EXPEDITION

Shell Oil Company (Shell), pursuant to Section 1.7 of the Commission's Rules of Practice and Procedure and Sections 4 and 7 of the Natural Gas Act and the Rules and Regulations thereunder, respectfully petitions this Commission to:

(a) Authorize Shell to charge and collect from United Gas Pipe Line Company (United) increased rates to reflect increased royalty payments resulting from settlement of pending litigation with respect to certain gas sold by Shell to United pursuant to Shell's FPC Gas Rate Schedule No. 202, or, in the alternative, authorize Shell to abandon the sale of one-eighth of such gas, effective January 1, 1974, but in no event later than October 1, 1975;

(b) Waive Sections 154.93, 154.98, and 154.105 of the Commission's Regulations and Section 2.56a of its General Policy and Interpretations; and

(c) Provide shortened procedures by omitting the intermediate decision procedure, if a formal hearing is set, and by expediting these proceedings.

In support of its Petition, Shell respectfully shows as follows:

• • • •

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Shell sells gas produced from the Gibson Field, Terrebonne Parish, Louisiana, to United under Shell's FPC Rate Schedule No. 202. This sale was originally certificated in Docket No. G-5037 on May 28, 1956 at which time Shell's gas sales contract was designated as FPC Gas Rate Schedule No. 50. Upon the execution and filing of a replacement contract, dated May 1, 1959, the rate schedule designation was changed to No. 202, as noted in the Commission's Order dated June 11, 1959 in Docket No. G-18697 and the Commission's letter dated July 6, 1959.

A portion of the gas sold to United is produced from acreage covered by Mineral Lease dated August 29, 1934 (the 1934 lease) from F. B. Williams Cypress Company, Limited (now Williams, Inc.), to Shell Petroleum Corporation (now Shell) and by Mineral Lease dated July 24, 1952 (the 1952 lease) from Williams, Inc. to certain parties (which lease was assigned to Shell on January 24, 1955). A portion of the acreage covered by the 1934 lease was subleased to Union Producing Company (now Pennzoil Producing Company) on December 29, 1942. Certain portions of the 1934 lease have been unitized and are hereinafter referred to as "Unitized Acreage".

The 1934 lease provides for royalty of the gas production thereunder equal to one-eighth "of the value thereof, calculated at the market rate prevailing at the well", and the 1952 lease provides for royalty on the gas production thereunder equal to one-fourth "of the value thereof, calculated at the market price prevailing at the well".

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On June 7, 1973, and again on March 27, 1974, Williams, Inc. demanded payment by Shell for gas produced from acreage covered by these leases based on the so-called "market value" clauses contained therein. Further, on June 5, 1974, Williams, Inc. declared both the 1934 lease and the 1952 lease terminated because of Shell's alleged failure to pay the royalty claimed by Williams, Inc.

In order to protect its legal rights and interests in these leases, Shell and Pennzoil Producing (against whom similar demands were made by Williams, Inc.) filed a petition on May 24, 1974 in the Civil District Court in the Parish of Orleans, Louisiana (*Shell Oil Company and Pennzoil Producing Company* v. *Williams, Inc., et al.*, Docket No. 573-591) asking issuance of a judgment declaring that Shell and Pennzoil Producing are paying the appropriate royalty. By reconventional demand, Williams, Inc., requested the Court to order cancellation of both the 1934 lease and the 1952 lease effective June 5, 1974 and an accounting for, and payment based on the value of, all minerals produced under such leases since June 5, 1974.

Shell and Williams, Inc. have entered into a Settlement Agreement dated June 18, 1975 (attached hereto as Appendix A) which will permit Shell to retain both the 1934 lease and the 1952 lease and continue to sell natural gas to United for the interstate market upon the payment of higher royalties to Williams, Inc. The Settlement Agreement provides that Shell will make such applications to the Federal Power Commission as may be necessary to obtain authorization for the following:

(A) Payment by Shell of royalty on each Mcf produced and sold from Unitized Acreage and under the 1952 lease, equal to one-eighth in the case of the Unit-

ized Acreage and one-fourth in the case of the 1952 lease, of the total of:

(1) the higher of

(a) the base royalty rate, or

(b) the base alternative rate, plus

(2) 7¢ or the full amount of the Louisiana severance tax, which amount is to be

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increased as the severance tax of the State of Louisiana is increased, plus

(3) the full amount of federal taxes imposed upon Williams, Inc., plus

(4) any upward or downward adjustment for Btu content of the gas containing more or less than 1,000 Btu per cubic foot, and

pass through to United of the portion of such total which exceeds current royalty payments by Shell to Williams, Inc.

In connection with the above, "base royalty rate" is 78¢/Mcf as of January 1, 1975, increasing 1.5¢/Mcf each January 1st beginning January 1, 1976. "Base alternative rate" is 150 percent of the highest area or national rate permitted or, in the case of deregulation of interstate gas sales, is the average of the three highest prices provided in sales for resale in the South Louisiana area; or

(B) Abandonment of that share of the gas sold under said leases which is attributable to Williams, Inc., royalty interests.

In addition, the Settlement Agreement provides for Shell to deliver royalty gas to Williams, Inc., in the event abandonment authorization is granted pursuant to (B) above, and further to pay Williams, Inc. the sum of the royalty which would have been paid during 1974 if Shell's sales

price during such period had been 45¢/Mcf, less royalty actually paid, plue the royalty due if the Commission approves (A) above, all as more fully spelled out in Article II of the Settlement Agreement attached hereto as Appendix A.

Shell requests that the Commission issue its approval as requested herein effective January 1, 1974. If the Commission fails to issue its Order authorizing either (A) or (B) above, or other acceptable authorization before February 1, 1976, either party may terminate the Settlement Agreement.

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IV.

By Letter Agreement dated June 23, 1975 (Appendix B hereto) Shell and United have amended the Gas Purchase Contract dated May 1, 1959, covering the gas sold from the Gibson Field to provide for payment by United to Shell of any increased royalty amounts authorized by Order of this Commission. In the event the FPC authorizes abandonment of the interest attributable to Williams, Inc., United will amend the May 1, 1959 Contract so as to reflect release of that gas from the Contract. This Letter Agreement is also being filed concurrently herewith as a supplement to Shell's Rate Schedule No. 202.

Promptly upon Commission authorization of (A) above Shell will file a notice of rate change pursuant to Section 154.94 of the Commission's Regulations reflecting the increased rate for the volumes of gas sold thereafter, and also containing a surcharge for royalty on volumes delivered between January 1, 1974 and Date of Final Order, at the settlement rate specified in the Settlement Agreement.

V.

Shell is a natural gas company under the Natural Gas Act and the rates collected for sales of natural gas in interstate commerce for resale are subject to the jurisdiction of this Commission. In this respect, the rates collected for the sale of gas to United pursuant to FPC Rate Schedule No. 202 are governed by the rates established by this Commission in the Southern Louisiana Area Rate Case[1] and the National Rate Case[2]. The increased royalties payable pursuant to the Settlement Agreement render the rates authorized by Opinion Nos. 598 and

[290]

699-H inappropriate. The U.S. Court of Appeals for the Fifth Circuit specifically authorized the relief sought by this Petition by stating:

> "If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief."[3]

and

> "If the royalty obligations are such as to make the rates established by Op:598, and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will certainly have recourse to the administrative process."[4]

In the above referred to litigation, Williams, Inc. is vigorously seeking cancellation of the 1934 and 1952 leases on

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[1] Opinion Nos. 598 and 598-A issued July 16, 1971, and September 9, 1971, respectively, 46 F.P.C. 86 and ... F.P.C. ...; affirmed in *Placid Oil Co., et al.* v. *F.P.C.*, 483 F.2d 880 (5th Cir. 1973); affirmed *Mobil Oil Corp., et al.* v. *F.P.C.*, 417 U.S. 283 (1974).

[2] Opinion No. 699 issued June 21, 1974, ... F.P.C. ...; appeal pending *Shell Oil Company, et al.*, v. *F.P.C.*, Nos. 74-3330, *et al.*

[3] *Placid Oil Co., et al.* v. *F.P.C.*, 483 F.2d 880, at 911.

[4] *Id.*

the basis of failure by Shell to pay royalty on so-called "market value". In the face of this litigation, the special relief requested by Shell herein, which would terminate this litigation if granted, is needed by Shell now in order to be effective. United is in a severe curtailment situation at this time and, as evidenced by Appendix B is willing to pay higher prices in order to keep this gas in its system. Based on these facts, Shell believes the public interest would best be served in this proceeding by United retaining the gas produced from these leases for the interstate market even if such gas is at a slightly higher price to compensate Shell for the increased royalties to be paid Williams, Inc. pursuant to the Settlement Agreement.

VI.

Shell requests the Commission to act on this Petition as quickly as possible by providing:

(1) a shortened notice period, and

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(2) an abbreviated or accelerated hearing schedule, if this proceeding is set for formal hearing, including omission of the intermediate decision.

For the foregoing reasons, Shell respectfully requests the Commission to:

(1) authorize Shell to collect increased rates based upon payment of increased royalty, as more fully described herein, or, in the alternative, authorize abandonment of the royalty share of the gas, effective January 1, 1974, but in no event later than October 1, 1975;

(2) waive Sections 154.93, 154.98, and 154.105 of the Commission's Regulations and Section 2.56a of its General Policy and Interpretations; and

(3) provide shortened procedures as more fully described herein.

Respectfully submitted,

Thomas G. Johnson
William G. Riddoch
William A. Wood
Attorneys for
SHELL OIL COMPANY

By /s/ WILLIAM G. RIDDOCH
William G. Riddoch

July 16, 1975
Houston, Texas

• • • •

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APPENDIX A

SETTLEMENT AGREEMENT

THIS AGREEMENT is made this 18th day of June, 1975, by and between Pennzoil Producing Company ("Producing"), Shell Oil Company ("Shell") (Producing and Shell being hereinafter jointly referred to as "Lessees") and Williams, Inc. and the remaining royalty owners listed on Annex A to this agreement (hereinafter sometimes collectively referred to as "Lessor").

W I T N E S S E T H :

WHEREAS, by Mineral Lease dated August 29, 1934, F. B. Williams Cypress Company, Limited (now Williams, Inc.), granted certain mineral interests and rights to Shell Petroleum Corporation (now Shell Oil Company), (said Mineral Lease being hereinafter sometimes referred to as "1934 Lease");

WHEREAS, by instrument dated December 29, 1942, Shell subleased certain of its rights and interests to a portion of the acreage covered by the 1934 Lease to Union Producing Company (now Producing);

WHEREAS, certain portions of the acreage covered by the 1934 Lease have been unitized, such portions being herein referred to as "Unitized Acreage";

WHEREAS, by Mineral Lease dated July 24, 1952, Williams, Inc. granted certain mineral interests and rights to certain parties and those interests and rights were assigned to Shell on January 24, 1955 (said Mineral Lease being hereinafter sometimes referred to as "1952 Lease";

WHEREAS, the 1934 Lease provides for royalty of the gas production thereunder equal to one-eighth "of the value

thereof, calculated at the market rate prevailing at the well", and the 1952 Lease provides for

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royalty on the gas production thereunder equal to one-fourth "of the value thereof, calculated at the market price prevailing at the well";

WHEREAS, Lessor has demanded payment of gas royalty amounts which it asserts were underpaid by Lessees under the 1934 Lease and the 1952 Lease for a period commencing October 1, 1971;

WHEREAS, in judicial proceedings Lessor has demanded cancellation and termination of the 1934 and 1952 leases due to the Lessor's assertion that the Lessees have failed to pay the proper royalties due under the leases;

WHEREAS, there is presently pending on the docket of the Civil District Court for the Parish of Orleans, State of Louisiana, civil litigation in which the rights and obligations of the parties concerning royalty payments under the aforesaid leases are being contested;

WHEREAS, Lessees have asserted that they have paid and are still paying the royalties which have been legally due; and

WHEREAS, the parties desire to avoid further disputes and to set at rest the issue in pending litigation.

NOW, THEREFORE, the parties agree as follows:

I.

Lessees agreed promptly to perfect such applications with the Federal Power Commission (hereinafter referred to as "FPC") as may be necessary to obtain FPC authorization for the following with respect to gas produced and sold from said Leases:

A. (Both (i) payment by Producing to Lessor of royalty on each Mcf of gas Producing produces and sells from Unitized Acreage, and payment by Shell of royalty on each Mcf it produces and sells from Unitized Acreage and under the 1952 Lease, equal to one-

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eighth (1/8) in the case of Unitized Acreage and one-fourth (1/4) in the case of the 1952 Lease, of the total of (1), (2), (3) and (4) as follows:

(1) the higher of

(a) the "base royalty rate" as hereinafter defined, or

(b) the "base alternative rate" as hereinafter defined, plus

(2) 7¢ or the full amount of the Louisiana severance tax, which amount is to be increased as the severance tax of the State of Louisiana is increased, and plus

(3) the full amount of federal taxes imposed upon Lessor for the severance or production of such gas should such taxes be imposed, less any portion of such tax which may be specified by the FPC as being included in any rate which forms the basis of the base alternative rate; plus

(4) any adjustments for gas containing more or less than 1,000 Btu's per cubic foot utilizing the formula for Btu adjustments set out in FPC Opinion No. 699-H,

and (ii) receipt by Lessees from United Gas Pipe Line Company (hereinafter referred to as "United") of the portion of such total

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which exceeds one-eighth (1/8) or one-fourth (1/4), as the case may be, of the total price (including all adjustments)

which Lessees would receive from United for the sale of such gas in the absence of this agreement and of such FPC authorization.

The following definitions shall apply to the above:

1. The "base royalty rate" shall be 78¢ per Mcf for 1975 and shall increase 1.5¢ per Mcf each January 1 beginning January 1, 1976.

2. The "base alternative rate" shall be 150% of the "highest rate" prescribed or permitted by the FPC (or by any successor Federal agency having authority to review or establish rates for natural gas flowing in interstate commerce) for natural gas flowing in interstate commerce from any area in the lower forty-eight states in which Producing or Shell are making interstate sales of natural gas; provided, however, that in determining such "highest rate," only those rates of general applicability, such as the "national rate" which are prescribed or permitted with respect to sales of gas at the wellhead shall be considered, and there shall be excluded from consideration any rates prescribed or permitted with respect to sales made pursuant to:

(i) contracts with small producers,

(ii) contracts for emergency sales,

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(iii) contracts having a term of less than one year, and

(iv) contracts made in accordance with FPC Orders 455, 455-A and 455-B.

There also shall be excluded from consideration rates prescribed or permitted by the FPC:

(i) pursuant to petitions for special relief, excluding the Petition to be filed by lessees pursuant to this agreement, and other documents hereunder to be filed by Lessees,

(ii) under unilateral producer filings,

(iii) for liquefied natural gas in liquid or regasified states, and

(iv) for synthetic gas, even if it be defined as natural gas.

Such "highest rate" shall be determined consistent with the fifty cent (50¢) per Mcf base rate specified in FPC Opinion No. 699-H, or similar successor opinions, including all increases in that rate but excluding, for the determination of such base alternative rate, any adjustments for gathering allowance and production, severance and similar taxes, but adjusted to a pressure base of 15.025 psia, but as noted above the "base alternative rate" shall be 150% of the "highest rate."

3. On the date that the price of natural gas sold by Producers in interstate commerce for resale ceases to be subject to price

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regulation by the FPC (or any successor agency), or to the extent such deregulation is applicable to the gas produced under the 1934 Lease or the 1952 Lease, whichever first occurs, the parties agree that the "base alternative rate" shall be determined only once for each calendar year and, when so determined, shall be effective hereunder for the entirety of such calendar year. In such case, the "base alternative rate" shall be equal to the average of the three highest wellhead rates provided in separate contracts for the sale of gas for resale, effectual on or before January 1 of the calendar year for which the base alternative rate is being determined for gas to be delivered in interstate commerce during such calendar year from the portion of the southern Louisiana area located within the state of Louisiana, as such area is defined in F.P.C. Opinion 546 (and Shell and Producing will each provide Lessor with satisfactory evidence of the price contained in the three highest contracts used by them in computing the "base alternative rate" and the price contained in their

own highest price contracts in such area); provided, however, in determining the average rate there shall be excluded from consideration any rates:

(i) prescribed in contracts having a term of less than one year, or

(ii) payable for liquefied natural gas in liquid or regasified state, or

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(iii) payable for synthetic gas, even if it be defined as natural gas, or

(iv) set forth in contracts for direct sales from another pipeline.

In determining the three highest rates, appropriate adjustment shall be made to those three highest rates for contract variances, which adjustment shall include only:

(i) Btu,

(ii) pressure base,

(iii) gathering allowance (if delivery point is other than the wellhead),

(iv) compression allowances, and

(v) taxes;

in order that the base alternative rate shall be exclusive of any adjustments for such items. The amount of such adjustment shall be only to the extent ordinarily and customarily made in the gas industry, and the lessees shall provide lessor with copies of their calculations, if any, for such contract variances.

Such average rate shall be adjusted to a pressure base of 15.025 psia; or

B. Delivery by Lessees to Lessor of one-eighth (⅛) or one-fourth (¼), as the case may be, of the gas attributable to Lessees' respective interests in the Unitized Acreage

and under the 1952 Lease, in kind, for use or sale by Lessor to any market.

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C. Lessees agree to request the FPC to issue its order effective January 1, 1974.

II.

A. If the FPC authorizes the procedures described in A. or B. of Section I. hereof, or any other procedure acceptable to all parties hereto, then on the first day an FPC order containing such authorization may first be appealed (that is, by the filing of a notice of appeal with the United States Court of Appeals) under Section 19 of the Natural Gas Act, 15 U.S.C. § 717(r) (the Date of Final Order), the procedure which was so authorized by the FPC shall be implemented. Any gas not delivered in kind under subsection B. of Section I. between the effective date of such order and the Date of Final Order shall be delivered as soon as practicable, but any such "make-up" deliveries shall be completed during a period which shall not exceed one-half (½) of the time expired between the effective date of such order and the Date of Final Order.

B. In addition, within thirty (30) days after the Date of Final Order, Lessees shall remit to Lessor the sum of:

(a) the royalty which would have been paid on volumes delivered during 1974 had Lessees' sale price for such gas been 45¢ per Mcf, less the royalty which has in fact been paid but only to the extent the FPC permits Lessees to recover such amounts from United, plus

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(b) (if the Commission approves Section I.A. hereof but not Section I.B.) the royalty specified in Section I.A. for the period commencing with the earlier of:

(i) the effective date of said order, but not earlier than January 1, 1975, or

(ii) October 1, 1975,

and ending on the Date of the Final Order.

Said sums together shall be deemed to constitute full and complete satisfaction of all claims for royalty on gas produced and sold by Lessees from the Unitized Acreage and under the 1952 Lease prior to the Date of Final Order.

III.

Upon acceptance of the FPC authorization described in the preceding Section II., the procedure so authorized shall amend the 1934 Lease and the 1952 Lease, effective on the effective date of such authorization or October 1, 1975, whichever occurs first, to provide that the procedure authorized by the FPC and accepted by the parties hereto shall constitute the sole agreements between such parties as to payment of gas royalties with respect to gas produced from the Unitized Acreage and under the 1952 Lease, subject to the restrictions of Section VIII.B. Further, neither Lessor nor any heirs, successors or assigns of Lessor shall make any claim or demand or bring any action to recover from Lessees or their successors or assigns any gas royalty on gas produced from Unitized Acreage or under the 1952 Lease prior to the effective date of said FPC order or October 1, 1975, whichever occurs first.

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IV.

A. Within ten (10) days after the expiration and termination of all appeals, petitions for rehearings, or petitions for writ of certiorari with any court or the FPC, and the expiration and termination of all rights and time periods within which to file appeals petitions for rehearing, petitions for writs of certiorari, with any court or the FPC, of any person or party as to the FPC authorization described in the preceding Section II., and after the FPC authorization herein in all respects is absolutely final and non-appealable as to all parties or persons whatsoever, the parties hereto shall jointly move to dismiss, with prejudice, those claims pending between Lessor and Lessees in *Shell Oil Company & Pennzoil Producing Company* v. *Williams, Inc., et al.,* Docket No. 573-591 in the Civil District Court for the Parish of Orleans in the State of Louisiana; but such dismissal shall not take place prior to the initial payment or delivery of gas to Lessors under Section I hereof or prior to Lessees implementing the provisions of Section II hereof.

B. Within ten (10) days after execution of this Agreement, Lessors may amend their complaint to increase the stated value of gas and the parties hereto shall then jointly request the Court to stay all further proceedings in the above described action pending the disposition of proceedings at the FPC described herein subject to the reservation of rights in Section VIII.A. hereof, except that Lessees must answer the presently outstanding interrogatories.

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V.

In addition, Lessor agrees fully to cooperate with and support such applications and pleadings as Lessees find it necessary or appropriate to file with the FPC to effectuate the agreement set forth herein. Lessees shall forward to Williams, Inc. and their attorneys copies of all correspondence, documents, pleadings, petitions, or exhibits, of whatever nature which they or either of them forward or file with the FPC, with respect to the application to the FPC to be filed pursuant hereto.

VI.

A. Williams, Inc. represents and warrants that it is authorized to execute this agreement on behalf of all parties listed on Annex A hereof and agrees to indemnify Lessees for any and all losses, damages, expenses and fees, including attorneys' fees, that may be sustained by Lessees as a result of lack of any such authority in Williams, Inc.

B. The undersigned signatories of each lessee represent and warrant that they have been fully authorized to execute this agreement on behalf of their respective corporations.

VII.

C. This agreement shall be binding upon and inure to the benefit of and be enforceable by the respective heirs, successors and assigns of the parties hereto.

VIII.

A. Lessees agree to use their best efforts to obtain the approval of the FPC to the procedures described in Section I. hereof. If the FPC refuses to authorize one of the procedures described in Section I. hereof,

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or fails to issue other authorization acceptable to the parties hereto, on or before February 1, 1976, either Lessor or Lessees, acting together, may terminate this agreement by giving written notice of same to the other. In such event, neither this agreement nor any provision hereof shall constitute or be used as evidence in any pending or ensuing litigation between the parties hereto.

B. If any final order issued with respect to this agreement is reversed, remanded or modified by any court by an order which itself becomes final, then upon such event this agreement shall be terminated and gas delivered to Lessor

under this agreement shall be returned promptly to lessees and any monies paid under this agreement in excess of that which would have been paid or delivered in the absence of this agreement shall be returned within thirty days after such event. In such event, the 1934 lease and 1952 lease shall in no way be amended or modified by this agreement, and Section III hereof in such case shall not take effect.

IN WITNESS WHEREOF, this Agreement is executed as of the date and year first above written.

* * * *

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ANNEX A

ROYALTY OWNERS IN THE GIBSON FIELD

Name and Address

Williams, Inc.
1323 Whitney Bank Building
New Orleans, Louisiana 70130

Succession of Laurence M. Williams
1323 Whitney Bank Building
New Orleans, Louisiana 70130

Mrs. Katharine W. Tremaine
1050 Coyote Road
Santa Barbara, California 93108

Through January 10, 1974:
The Kemper & Leila Williams
Foundation u/w Leila M. Williams
c/o First National Bank of Commerce
210 Baronne Street
New Orleans, Louisiana 70112

On January 11, 1974, The Kemper & Leila Williams Foundation u/w Leila M. Williams and The Kemper & Leila Williams Foundation u/w L. Kemper Williams were consolidated.

The Kemper & Leila Williams Foundation
c/o First National Bank of Commerce
210 Baronne Street
New Orleans, Louisiana 70112

F. B. Williams, as Executor of the Succession of Mrs. Delphine C. Williams
1323 Whitney Bank Building
New Orleans, Louisiana 70130

Frank B. Williams
1323 Whitney Bank Building
New Orleans, Louisiana 70130

Alec Andrew Johnson
11405 Arroyo Avenue
Santa Ana, California 92705

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Lucille W. Mayfield Trust for Ann Marsak
c/o First National Bank of Commerce
210 Baronne Street
New Orleans, Louisiana 70112

Elizabeth Williams
Post Office Box 1007
Solvang, California 93463

Elizabeth Williams Trust
Elizabeth Williams,
Frank B. Williams,
Alec Andrew Johnson, Trustees
1323 Whitney Bank Building
New Orleans, Louisiana 70130

Ann Marsak
135 Miramar Avenue
Santa Barbara, California 93108

Lucille W. Mayfield Trust for Alec Andrew Johnson
c/o First National Bank of Commerce
210 Baronne Street
New Orleans, Louisiana 70112

Heirs of Cora Clark:

Mrs. Elizabeth Campbell Brooks
Prospect Street
Litchfield, Connecticut 06759

Whitney.L. Brooks, Trustee
P. O. Box 148
Torrington, Connecticut 06790

Allan Adams Campbell
Rising Corners
West Suffield, Connecticut 06093

Valley Bank & Trust Company
Executor u/w Holbrook Campbell
1500 Main Street
Springfield, Massachusetts 01115

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APPENDIX B

June 23, 1975

United Gas Pipe Line Company
P. O. Box 1478
Houston, Texas 77001

Gentlemen:

Please refer to that certain gas purchase contract affective May 1, 1959, as heretofore amended ("Contract"), by and between United Gas Pipe Line Company, as Buyer, and Shell Oil Company, as Seller, under the terms of which Buyer is purchasing from Seller merchantable natural gas produced from certain lands and leaseholds located in Gibson Field, Terrebonne Parish, Louisiana. Seller has advised, as a result of litigation pending in *Shell Oil Company and Pennzoil Producing Company* v. *Williams, Inc., et al.*, Docket No. 573-591 (Civil District Court for the Parish of Orleans, State of Louisiana), that Seller may be required to make royalty payments to its lessors at a rate in excess of the rate heretofore paid as royalty or that in the absence of such greater royalty payments certain lessors have threatened to terminate some of the underlying leases. Seller has also advised that it is likely that other royalty owners in the Gibson Field will make similar demands. Seller has also advised that pursuant to a Settlement Agreement between Seller and certain of Seller's lessors, a copy of which is attached hereto as Exhibit A, payment of increased royalties or release of one-eighth of the gas back to such lessors may be required or permitted by the Federal Power Commission. In order to avoid the termination of leases and loss of gas to Seller and Buyer, Seller has requested that Buyer reimburse Seller for such excess payment for each of its lessors in the Gibson Field

or, in the alternative, release the royalty portion of the gas from the terms of the Contract. Buyer is agreeable to such arrangement on the following terms; accordingly, the parties hereto do hereby agree as follows:

1.

In the event Seller receives authorization from the Federal Power Commission to collect from Buyer increased sums payable to Seller's lessors as royalty on gas delivered after January 1, 1974, under the Contract, Buyer shall, beginning on the date Seller is authorized to collect such amounts, pay to

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Seller such sums covering the periods authorized by the Federal Power Commission. Any payments authorized by the Federal Power Commission for royalty gas delivered after January 1, 1974, through the date of the Federal Power Commission's final order, shall be amortized over a period of one year from the date of the Federal Power Commission's final order. In the event of the cessation of Federal Power Commission regulation of producer gas sales as described in Exhibit A hereto, Buyer shall at all times pay to Seller the sums necessary to permit Seller to pay each of its lessors in the Gibson Field who have the right to receive a royalty on gas sold from such field by Seller to Buyer (regardless of whether such lessor is a party to the attached Exhibit A) the royalties specified in Exhibit A hereto; such payments shall be made from time to time as necessary to permit Seller to remit such sums to its lessors in a timely fashion and without regard to any other provision of the (May 1, 1959) Contract, except as amended hereby.

This Section 1 of this amendatory agreement shall automatically become void and of no force or effect on the date

the Settlement Agreement attached hereto as Exhibit A is terminated pursuant to the terms thereof.

2.

In the event Seller receives authorization from the Federal Power Commission to abandon or release to its lessors one-eighth (1/8) of such gas, Buyer will amend the Contract in such manner as to effect the release of such one-eighth (1/8) of such gas from the terms and provisions of the Contract; provided that Buyer will have no obligation under Sections 1 and 2 hereof unless and until either of the alternative authorizations is granted by final order of the Federal Power Commission as contemplated hereby.

3.

By its execution hereof Buyer does not become a party to, an obligor or guarantor under, beneficiary of or bound in any way by the Settlement Agreement attached hereto as Exhibit A.

4.

This agreement shall become effective as of the date first hereinabove written.

5.

This agreement is subject to all present and future orders, rules and regulations of any governmental or regulatory body having jurisdiction.

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If the foregoing is in accordance with your understanding of the agreement between us, please so signify by executing the duplicate originals hereof in the space provided below and returning one of such originals to us. On our execution hereof, this agreement shall constitute an

amendment to the Contract and shall be binding upon us and upon our respective successors and assigns.

Very truly yours,

SHELL OIL COMPANY

By S. M. PAINE
S. M. Paine
General Manager
Production

ACCEPTED AND AGREED TO:

UNITED GAS PIPE LINE COMPANY

By D. LAMAR SMITH

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners:

John N. Nassikas, Chairman;
William L. Springer, and Don S. Smith.

PENNZOIL PRODUCING COMPANY

Docket No. RI76-8

SHELL OIL COMPANY

Docket No. RI76-10

ORDER DENYING PETITIONS FOR SPECIAL RELIEF, SETTING DATE FOR HEARING ON APPLICATIONS FOR ABANDONMENT, AND CONSOLIDATING FILINGS

(Issued August 29, 1975)

On July 1, 1975 and July 18, 1975, Pennzoil Producing Company (Pennzoil) and Shell Oil Company (Shell), respectively, filed petitions in Docket Nos. RI76-8 and 76-10 for special relief from the just and reasonable rates under Opinion Nos. 598 and 699, as amended. The relief sought was for certain gas from the Gibson Field, Terrebonne Parish, Louisiana, under lease from Williams, Inc. *et al,* (Williams) and which is being sold to United Gas Pipe Line Company under FPC Gas Rate Schedule Nos. 234 (Pennzoil) and 202 (Shell). In the alternative, both petitioners requested authorization to abandon the royalty share of gas, effective January 1, 1974, but no later than October 1, 1975.

The gas is produced from acreage covered by leases with Williams dated August 29, 1934, and July 24, 1952. The 1934 lease provides that Pennzoil and Shell make royalty payments on the gas production thereunder equal to ⅛ of the market value prevailing at the well. The 1952 lease between Williams and Shell provides for royalty equal to ¼ of that value. In letters dated June 7, 1973, the March 27, 1974,

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Williams demanded increased payments based on the market value clauses in the leases. His demands unmet, Williams declared both leases terminated on June 5, 1974. A lawsuit ensued out of which a settlement agreement dated June 18, 1975, was signed. That agreement provides that the instant petitions would be filed with the Commission seeking authorization for either of the following:

(A) Payment of royalty on each Mcf produced from the 1934 lease equal to ⅛, and from the 1952 lease equal to ¼ of the total of:

(1) the higher of

(A) the base royalty rate or

(B) the base alternative rate, plus

(2) 7¢ per Mcf or the full amount of the Louisiana severance tax, plus

(3) any Btu adjustments from 1000 Btu's

The "base royalty rate" is 78¢ per Mcf for 1975 and will increase 1.5¢ per Mcf annually beginning January 1, 1976. "Base alternative rate" is 150% of the highest area or national rate permitted or, in the case of deregulation, is the average of the three highest prices provided in sales for resale in the South Louisiana area; *or*

(B) Abandonment of that share of the gas sold under the leases attributable to Williams' royalty interests.

Should we take the course outlined in (A), Petitioners and United would amend their 1959 contract to provide for increased royalty payments by United which payments they request be made effective January 1, 1974, but no later than October 1, 1975. Petitioners' filing for the royalty increase will also contain a surcharge for royalty on volumes delivered between January 1, 1974, and the date of the Commission's final order.

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In the event we authorized (B), United agreed to amend the 1959 contract to reflect the release of the royalty portion of the gas from the contract. A further proviso to the settlement agreement would permit cancellation of the agreement by either party should we not grant authorization prior to February 1, 1976. Due to the time limitation stated above, Petitioners also requested accelerated procedures, including the waiver of the intermediate decision, if a formal hearing were held.

The basic thrust of Petitioners' argument is that, pursuant to *Placid Oil Co. et al.* v. *F.P.C.*, 483 F.2d 880 (5th Cir. 1973), the Commission may grant special relief where higher than average royalties make a rate charged inappropriate. Petitioners state that United Gas Pipe Line Company, to whom they sell the gas, is in severe curtailment and is willing to pay the higher prices to keep the gas in its systems. Therefore, Petitioners argue, the public convenience and necessity warrants United's retaining this gas at the higher prices rather than risking termination of the leases in question and the possible diversion of the gas thereunder to the intrastate market.

The Commission finds:

(1) There is no justification for allowing a producer to pass through higher royalty costs to the consumer without a showing that Petitioners' overall costs are higher than those reflected in our Opinion No. 699-H.

(2) There is no basis for allowing a temporary surcharge for the purpose of permitting a producer to recover retroactive royalty payments.

(3) It is in the public interest that the petitions, insofar as they request abandonment of the gas subject to the royalty owner's interest, be set for hearing.

(4) Inasmuch as the petitions of Shell and Pennzoil involve identical issues and parties, the public interest will be served by disposing of these matters in the same hearing.

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(5) The requested shortened hearing procedures with respect to accelerated dates is hereby granted. However, no good cause exists for granting the request for waiver and omission of the intermediate decision.

The Commission orders:

(A) Those portions of the petitions (A) filed by Pennzoil and Shell in Docket Nos. RI76-8 and RI76-10 relating to a request for rate increases due to increases in royalty payments are hereby denied.

(B) Those portions of the petitions relating to temporary surcharges for back royalty payments by Shell and Pennzoil are hereby denied.

(C) Pursuant to the Natural Gas Act, particularly Sections 4, 5, 7, 15, and 16 thereof, the Commission's Rules of Practice and Procedure, and the regulations under the Act (18 CFR, Chapter I), those portions of the Shell-Pennzoil petitions relating to the abandonment of the gas associated with royalty owners' interests are set for the purpose of hearing and disposition.

(D) The portion of the petitions to abandon sales of royalty volumes filed by Pennzoil and Shell in Docket Nos. RI76-8 and RI76-10, respectively, are hereby consolidated for the purpose of hearing and disposition.

(E) A public hearing on the issues presented by the portion of the petitions to abandon sales of royalty volumes shall be held commencing September 23, 1975, at 10:00 A.M. (EDT) in a hearing room of the Federal Power Commission, 825 North Capitol Street, N.E., Washington, D.C. 20426.

(F) A Presiding Administrative Law Judge to be designated by the Chief Administrative Law Judge for that purpose (See Delegation of Authority, 18 CFR 3.5(d)), shall preside at the hearing in this proceeding pursuant to the Commission's Rules of Practice and Procedure. The Presiding Administrative Law Judge shall issue his initial decision on or before November 26, 1975.

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(G) Applicants and any intervenor supporting the application shall file their direct testimony and evidence on or before September 9, 1975. All testimony and evidence shall be served on the Presiding Administrative Law Judge, the Commission Staff, and all other parties to the proceeding.

(H) The Commission Staff and all intervenors opposing the application shall file their direct testimony and evidence on a date to be fixed by further order of the Presiding Administrative Law Judge. All such testimony and evidence shall be served upon the Presiding Administrative Law Judge and all other parties.

(I) Any party or Staff Counsel desiring to oppose any filed exceptions shall file such objections on or before December 19, 1975.

By the Commission.

(SEAL)

KENNETH F. PLUMB,
Secretary.

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners:
John N. Nassikas, Chairman;
William L. Springer, Don S. Smith,
and John H. Holloman III.

PENNZOIL PRODUCING COMPANY

Docket No. RI76-8

SHELL OIL COMPANY

Docket No. RI76-10

ORDER GRANTING APPLICATION FOR REHEARING, VACATING PORTION OF ORDER DENYING PETITION FOR SPECIAL RELIEF, AND GRANTING INTERVENTION

(Issued September 22, 1975)

On September 9, 1975, Pennzoil Producing Company (Pennzoil) filed herein an application for rehearing of the Commission's order issued in the above docket on August 29, 1975. The August 29 order rejected petitions for special relief by Pennzoil and Shell Oil Company from the just and reasonable rates for gas under lease in the Gibson Field, Terrebonne Parish, Louisiana. The petitions were filed as a result of demands by Williams, Inc. *et al.*, the lessor, for increased royalty payments based upon contractual market value royalty clauses. We rejected the petitions, finding no justification for allowing producers to pass through higher royalty costs without a showing that overall costs were higher than those set forth in Opinion No. 699-H.

In its application for rehearing, Pennzoil argues that, by excluding the rate increase request from being heard, the Commission is excluding consideration of the problems associated with "market value" royalty claims based on prices above those we have approved. Applicant also points out that this issue has been raised and set for hearing in *Roy M. Huffington*, Docket No. CI75-602. Pennzoil contends that foreclosing their right to present evidence which would justify the rate increase constitutes an "undue and unlawful discrimination against Pennzoil." We recognize the fact that identical issues have been raised in both proceedings. Therefore, we shall grant Pennzoil's request for rehearing. Upon our own motion we shall also apply this ruling to Shell Oil Company. Pennzoil has already submitted evidence relating to its petition for special relief. We shall give Shell the opportunity to do likewise, if it so desires.

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Good cause exists to permit the intervention of the following petitioners: Chevron Oil Company, Western Division; California Oil Company, a Division of Chevron Oil Company; United Gas Pipe Line Company; Southern Natural Gas; Associated Gas Distributors; Michigan Wisconsin Pipe Line Company; and Mississippi River Transmission Company.

The Commission orders:

(A) Pennzoil's application for rehearing filed herein September 9, 1975, is granted.

(B) That portion of the August 29, 1975 order denying Pennzoil's and Shell's petitions for special relief is hereby vacated.

(C) Shell Oil Company shall file any additional testimony and evidence relating to its request for authorization

to collect increased rates on a date to be fixed by further order of the Presiding Administrative Law Judge. Such testimony and evidence shall be served upon the Presiding Administrative Law Judge and all other parties.

(D) The above-named petitioners are permitted to intervene in this proceeding subject to the rules and regulations of this Commission; *Provided, however,* that the participation of such intervenors shall be limited to matters affecting asserted rights and interests as set forth in said petitions for leave to intervene; and *Provided, further,* that admission of such interests shall not be construed as recognition by the Commission that it might be aggrieved because of any order or orders entered in this proceeding.

By the Commission.

(SEAL)

KENNETH F. PLUMB,
Secretary.

[1]

BEFORE THE
FEDERAL POWER COMMISSION

Inthe Matter of:
PENNZOIL PRODUCING COMPANY
AND
SHELL OIL COMPANY

Docket Nos: RI-76-8 RI-76-10

Hearing Room "G"
825 North Capitol Street
Washington, D.C.
Tuesday, September 23, 1975

The hearing in the above-entitled matter met, pursuant to Notice, at 10:00 a.m.,

BEFORE:

SAMUEL Z. GORDON, Presiding Administrative Law Judge

• • • •

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PENNZOIL PRODUCING COMPANY

Direct Testimony of
A. DUNCAN GRAY, JR.

Q. Would you please state your name and business address?

A. My name is A. Duncan Gray, Jr. My business address is 900 Southwest Tower, Houston, Texas 77002.

Q. How are you employed?

A. I am General Attorney for Pennzoil Company (Pennzoil) — Oil and Gas Operations. I am also Vice President and General Attorney of Pennzoil Producing Company (Producing).

Q. Please outline your educational background and experience.

A. I graduated with an A.B. from Dartmouth College in 1960. I received a J.D. from the University of Michigan in 1963 and an L.L.M. (Taxation) from New York University in 1964. I practiced with Baker & Botts from 1964 through November of 1972 at which time I became the General Attorney for Pennzoil's Oil and Gas Operations as well as General Attorney of Producing. In August, 1974, I became a Vice President of Producing.

Q. What is the purpose of your testimony?

A. By its petition in this docket, Producing has requested the Commission to take action which will allow implementation of a settlement agreement reached in a lawsuit arising out of claims made by Williams, Inc. (Williams) as lessor-royalty owner against Producing and Shell Oil Co. (Shell) as lessees. I was intimately involved in the negotiations which led to that settlement. The purpose of my testimony is to describe the circumstances surrounding the lawsuit, the negotiations and elements of the settlement, and the evidentiary support for granting Producing's petition so as to allow implementation of the settlement.

Q. Would you please describe the factual background out of which the litigation between Producing and Williams arose?

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A. Producing and Shell produce and sell in interstate commerce gas from acreage in the Gibson Field, Terrebonne Parish, Louisiana, which is covered by a 1934 lease from Williams (then F. B. Williams Cypress Company,

Limited) to Shell (then Shell Petroleum Corporation). A portion of the acreage was subleased by Shell to Producing (then Union Producing Company) on December 29, 1942.

Q. To whom does Producing sell the gas it produces from the acreage covered by the 1934 lease?

A. Producing presently sells that gas in interstate commerce to United Gas Pipe Line Company (United) under Producing's Rate Schedule No. 234.

Q. What price does Producing receive for the gas?

A. Some is covered by Opinion No. 598 for which we receive 31.11¢ per Mcf, including all adjustments, and some is covered by the national rate at 59.88¢ per Mcf, including all adjustments.

Q. How did the lawsuit arise?

A. By letters dated June 7, 1973, and March 27, 1974, Williams demanded payment of royalty based upon so-called market values substantially in excess of the price the Commission permits us to receive from United. In addition, by letter dated June 5, 1974, Williams declared the lease terminated because of our alleged failure to pay the royalty which Williams claimed. In an attempt to prevent lease termination and imposition of such increased royalties, we filed suit against Williams in the Civil District Court in Orleans Parish, Louisiana, asking for a declaratory judgment that we are paying the correct royalty. By Reconventional Demand (counterclaim), Williams requested the Court to order (1) termination of the lease effective June 5, 1974, (2) an accounting for and payment of the value of all minerals produced under the lease since June 5, 1974, (3) payment of $1,055,204.62 in "underpaid" royalties for the period through May 31, 1974, and (4)

payment of damages and attorneys' fees. The "underpayment" of royalties was calculated on the basis of an increasing market value of gas up to 70¢ per Mcf for the period from November, 1973, through May, 1974. Williams has since amended its Reconventional Demand to cover the period from June 1, 1974, through April 30, 1975, alleging additional underpayments of royalties by Producing of $1,989,222.91 based on an alleged market value of $1.30 per Mcf from June 1, 1974, through December 31, 1974, and $1.40 per Mcf from January 1, 1975, through April 30, 1975. Basically, these mineral owners want the lease terminated for what they

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perceive to be an intentional breach of the obligation of the mineral lessee to pay royalties due. The Reconventional Demand claimed default in Producing's obligation and termination of the lease and asks the Louisiana court to recognize and decree a termination, and order Producing and Shell off the lease, returning full possession of the minerals and rights of production to the mineral owners.

Q. Are you sponsoring any exhibits?

A. Yes. My exhibits are copies of, first, the June 7, 1973, letter, second, the March 27, 1974, letter, third, the June 5, 1974, letter, fourth, our complaint in the lawsuit, fifth, Williams' Reconventional Demand and, sixth, Williams' recent amendment to its Reconventional Demand.

Q. Please briefly describe the basic provisions of the settlement agreement.

A. The description in Section IV of our application succinctly and accurately describes the settlement agreement and I hereby adopt that description as my answer.

Q. Is there a possibility of substantial damages, increased royalties or lease termination if the lawsuit continues?

A. I am not a Louisiana lawyer and I will not purport to testify as to what the Louisiana court will hold. However, Williams, Inc. is vigorously prosecuting its claims and we are forced to consider this a serious lawsuit.

Q. Why did Producing enter into the settlement agreement?

A. We entered into the settlement agreement because we believe that either payment of increased royalties by the consumers of gas or the abandonment of the royalty share of the gas is preferable to the risk of either losing all the gas or the imposition by a court of damages and royalties which might be substantially higher than those contemplated by the settlement agreement.

Q. Is there a risk that the court could impose royalties in excess of those set out in the settlement agreement?

A. The settlement agreement would base royalty on the higher of (a) 78¢ for 1975 plus 1.5¢ per year or (b) 150% of the national rate or, in the event of deregulation, the average of the three highest prices in producer sale for resale contracts in the South Louisiana area. Williams'

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demand is for royalty based on $1.40 per Mcf from January 1 through April 30, 1975. We do not know what market value they will allege for the period after April 30, 1975, but I think we can expect allegations of market value in excess of $1.40 per Mcf.

Q. Addressing solely the abandonment issue; why would it be in the public interest to permit Producing to abandon the royalty gas?

A. The risk is the possibility of lease termination or even higher royalties. United and its customers would be better served by giving up one-eighth of this gas than running the risk of losing it all, or of having a court impose much higher royalties and damages which might possibly then be passed on to the consumer in whole or in part.

Q. Why would it not be best for Producing itself to simply absorb any such damages and royalties?

A. That would not benefit anyone except the royalty owner and would in fact be detrimental to the public interest. The royalty owner would get more money but we would have that much less funds available for exploration and development of this lease as well as other leases. It seems that when gas is in short supply all efforts should be made to ensure that such a result would not occur.

Q. Why would it not be best just to let the lawsuit proceed?

A. For all the reasons I have given above as to why the settlement is in the public interest, plus the fact that if the lease were terminated and the gas lost to United and its customers, this result arguably could be a precedent for the other so-called market value leases in Louisiana. The ultimate loss of gas to the interstate market could be very substantial. As you know, there is a substantial question whether, if the lease is terminated, the gas could under the Natural Gas Act be diverted from the interstate market. While the Commission has ruled on that in *El Paso* (Opinion No. 737), that case is subject to appeal and may well be reversed. Even if the lease is terminated and if it is ultimately determined that Williams must continue to sell the gas to United, Williams may be able to collect the national rate, or even 130% of the national rate under the Commission's recent small producer order, for all of the gas instead

of the roughly one-third which currently qualifies for the national rate; if that happened, United and its customers might well end up paying more for this gas than they would if the royalty flow-through is allowed. The

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ultimate answer to that question is unknowable at this time, but the settlement would avoid that risk.

Q. Addressing the royalty flow-through question, what would be the rate effect of permitting payment and flow-through to United of the increased royalty under the settlement?

A. As an example, if Producing is permitted to collect the increased royalty on July 1, 1975, the increased royalty for volumes delivered through each month remaining in 1975 will average 8.0017¢ per Mcf, including Btu adjustment. The surcharge, if placed into effect July 1, 1975, will be 8.6457¢ per Mcf, including Btu adjustment; 5.4205¢ of that total will be attributable to volumes delivered between January 1, 1975 and July 1, 1975, and the remaining 3.2252¢ per Mcf will be attributable to volumes delivered during 1974.

Q. Why would it be in the public interest to permit Producing to pay the increased royalty set out in the agreement and flow it through to United?

A. It would be in the public interest for all the reasons which I described above, plus it would assure that United and its customers would get all this gas instead of perhaps only seven-eighths or even none.

Q. Which of the two alternatives set out in the settlement agreement — increased royalty payments or abandonment — would be preferable?

A. So far as United and its customers are concerned, my opinion would be that they would be better off being assured of all the gas at a slightly higher price than receiving only seven-eighths of it or perhaps none. It is interesting to note that, to the best of my knowledge, none of United's customers who would have to pay the increased royalty are opposing our application. I think it is also significant that if the settlement is approved Producing will not receive any additional revenue.

* * * *

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MR. STEVENS: Your Honor, I have a couple of questions for Mr. Gray, as supplementary direct, before I tender him for cross examination.

PRESIDING JUDGE: Very well.

BY MR. STEVENS:

Q. Mr. Gray, regarding the Williams 1934 lease, which is one of the subjects of this proceeding, does Producing have any development plans for that property for the next year or so?

A. Our operating people in our Lafayette, Louisiana office tell me that we have, during 1976, one development well and one work-over of an existing well planned.

The development well will be drilled to a shallow, 2,200-foot sand, and the work-over would be recompletion of an existing well in a shallower sand.

Q. What are the estimated reserves for each of those projects?

A. The estimated reserves? The reserves, as estimated by our operating people, are: The development well, which is the Pelican A-10, that well would produce 1.65 Bcf of gas; and the work-over, which is called the Koontz No. 13, would

produce from the sand, when it's recompleted, 2.42 Bcf of gas.

Q. Are those plans currently in Producing's budget?

A. Either they are in Producing's budget or they

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will be in Producing's budget as submitted by the Lafayette office for 1976.

Q. Will Producing do that work in 1976 if Producing is forced as a result of litigation in Louisiana to pay royalty based on $1.40 or above?

A. Again, our operating people tell me that the payment of royalty at $1.40 or above combined with a presently-available price for this gas of 52 cents would cause them to defer indefinitely these plans.

PRESIDING JUDGE: Excuse me. The royalty based on $1.40, or what would the royalty come to, actually?

MR. STEVENS: Judge, based on $1.40, it's one-eighth; it would be 17½ cents.

PRESIDING JUDGE: I see.

BY MR. STEVENS:

Q. Mr. Gray, you mentioned a price of 52 cents. I believe that's for new gas under the national rate.

Do you have an idea about what is Producing's average price to United for gas on the Williams lease, without btu adjustment or tax reimbursement?

A. It's approximately 36 cents.

Q. Do you have an estimate as to what that price would rise to if the Commission permits the royalty flow-through that we are requesting here?

A. The price would rise to approximately 44 cents

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per mcf.

Q. Do you have an estimate of what that price would rise to if the Commission allows both the royalty flow-through that we're requesting here plus the surcharge that we're requesting?

A. The price would be 52 cents for the next 12 months and then it would drop back to 44 cents.

Q. Do you have an estimate of what the price would be if the lease reverted to Williams and Williams continued to sell the gas to United, but was entitled to collect the small producer price?

A. The price would be approximately 68 cents, which is 52 cents which is the national rate for new gas, plus 16 cents which is 30 percent of 52 cents.

These prices, incidentally — all of the prices I've mentioned — are without the components for tax reimbursement or btu adjustment.

MR. STEVENS: Your Honor, we submit Mr. Gray for cross examination.

PRESIDING JUDGE: I don't know if you'd call it cross since your interests are exactly the same, but does Shell wish to examine?

MR. JOHNSON: No, Your Honor.

PRESIDING JUDGE: Does United?

MR. ARNETT: No, Your Honor.

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UNITED GAS PIPE LINE COMPANY

Prepared Testimony of
D. LAMAR SMITH

Q. Please state your name and business address.

A. D. Lamar Smith, 700 Milam, Houston, Texas.

Q. What is your position at United Gas Pipe Line Company?

A. Senior Vice President — Gas Supply.

Q. What is your educational background?

A. I graduated from Texas A & M University in 1958 with a B.S. Degree in Mechanical Engineering and from Southern Methodist University in 1961 with an LLB Degree. I am a member of the bar of the state of Texas.

Q. Please describe briefly your business and professional experience.

A. Upon graduation from law school in 1961, I was employed by Tennessee Gas Pipeline in its Planning Department. In December 1963, I joined Mobil Oil Corporation as a Natural Gas Attorney in New York City. In 1967 I was transferred from Mobil's Legal Department to its Natural Gas Unit where I participated in the negotiation of Mobil's major natural gas sales in the North American Exploration and Production Division. I left Mobil in December 1968, and from that time until December 1970, I practiced law as a partner in the law firm of Kerr & Smith in Ft. Stockton, Texas, and as General Counsel of Texas Crude Oil Company. In December 1970, I joined United Gas Pipe Line Company as an attorney. In November 1973, I was made Vice President — Gas Acquisition, and in June 1974, I was made Senior Vice President —Gas Supply.

Q. What corporate functions are under your direction and supervision?

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A. I am in charge of five corporate functions: (1) Gas Acquisition, (2) Reserves, (3) Proration and Deliverability, (4) Gas Purchase Contract Administration and (5) Gas Management.

Q. What is the purpose of your testimony in this proceeding?

A. I am presenting evidence on behalf of United concerning its agreements with Pennzoil Producing Company (Pennzoil) and Shell Oil Company (Shell) whereby United agreed, upon Commission approval, to pay higher rates to cover the claim of Williams, Inc. (Williams), lessor-royalty owner, for higher royalties or alternatively, to release the royalty portion of the gas from the gas purchase contracts.

Q. Are you submitting any exhibits in support of your testimony?

A. Yes.

Q. Will you please describe each of your exhibits?

A. Exhibit No. 7 (DLS-1) is the letter agreement between United and Pennzoil.

Exhibit No. 8 (DLS-2) is the letter agreement between United and Shell.

Q. What were the circumstances surrounding the execution of these agreements with Pennzoil and Shell?

A. Prior to my execution of these agreements on behalf of United, I was advised by Pennzoil and Shell that as a result of pending litigation in *Shell Oil Company and Pennzoil Producing Comapny* v. *Williams, Inc., et al.*, Docket No. 573-591 (Civil District Court for the Parish of Orleans,

State of Louisiana), that they may be required to make royalty payments to their lessors at a rate in excess of the rate heretofore paid as royalty or that in the absence of such greater royalty payments, certain lessors have threatened to terminate their leases. In fact, Williams had declared the leases terminated as of June 5, 1974, and this issue is presently before the court in the above-mentioned litigation. Further, I was also advised, that in an attempt to resolve the issues presented by this litigation, Pennzoil and Shell entered into a settlement

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agreement with Williams whereby they would, among other things, seek Commission approval of higher rates to United or abandonment of the royalty portion of the gas. United considers the issues presented by the so-called market value royalty litigation to be serious ones. If Williams is successful in obtaining lease termination, United and its customers may very well lose all the gas United is currently purchasing from the acreage covered by these leases. I therefore agreed to execute the letter agreements, pending Commission approval, to give effect to the settlement reached between the parties since it appeared to be in the best interest of United and its customers to do so. It is preferable from our standpoint, and we think from the standpoint of United's customers, to resolve this controversy as proposed by Pennzoil and Shell than to risk the loss of all the gas involved.

Q. Why do you believe that these agreements are in the best interest of United and its customers?

A. Concerned that the litigation between Pennzoil, Shell and Williams could result in the termination of the leases and loss of the gas, United agreed to pay higher rates based upon the increased royalty demand to keep the

entire package of gas in its system. If this first request were not allowed by the Commission, United then agreed that it would release the royalty portion of the gas in order to avoid the risk of losing the remaining portion of the gas. Of course, United preferred the first alternative over the second.

Q. What is the amount of gas involved.

A. In 1974, United purchased 25,588,412 Mcf from Pennzoil and 12,573,991 Mcf from Shell. On a daily basis this represents the purchase of approximately 70,105 Mcf from Pennzoil and 34,449 Mcf from Shell. The estimated remaining recoverable reserves as of January 1, 1975 in the Gibson Field attributable to Shell and Pennzoil were 68.7 Bcf and 86.2 Bcf, respectively.

Q. What is United's current gas supply situation?

A. As everyone is aware, United has a serious gas supply shortage and has been curtailing its customers on a continuous basis since November 1970. Projected curtailments for the year ending March 1976 are expected to exceed last year's curtailments. During this period of

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curtailment, United has continued to pursue a vigorous gas acquisition effort to add new gas to its system and to maintain that gas already in its system for the benefit of its customers.

Q. What is the possible effect of this proceeding on United's gas supply?

A. If the Commission approves the requests of Pennzoil and Shell to abandon the royalty portion of the gas, United will retain the major portion of the gas available to it from these leases. If the Commission had approved the increased rates, United would have of course been assured of the

continuing supply of all the gas at a higher price. Either alternative is preferable, however, to the possible loss of the entire amount of gas to United, its customers and interstate commerce.

Q. In your opinion does the public convenience and necessity require the Commission to approve abandonment of the royalty share of the gas under the circumstances as you understand them?

A. United would, of course, prefer to retain all of the gas available to it from these leases. In view of the uncertainty surrounding the outcome of the market value litigation in the state of Louisiana, the only way to ensure the retention of all the gas is to grant the request of Shell and Pennzoil for rate increases to cover Williams' demand for increased royalty payments. Unless the Commission reconsiders its action of August 29, 1975, foreclosing that relief, the public interest will be best served by the abandonment of the royalty gas and the retention of the larger portion of the gas, that which is attributable to the working interests. Otherwise, United and its customers are faced with the possible loss of all of the gas attributable to the leases in the event of an adverse decision by the Louisiana Courts. This would, of course, increase United's rate of curtailment which is already extremely high. During this period of acute gas shortages, United would certainly prefer to retain as much gas as possible. However, in this particular instance, United is faced with the possible loss of all the gas and therefore it has no alternative to the abandonment of the royalty portion of the gas.

Q. Does this conclude your testimony?

A. Yes.

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but I thought you gave two prices, one at 30.50 and one at 30.59. Is that wrong?

THE WITNESS: That's correct.

MR. JOHNSON: I didn't hear any figure then for the 30.50 in terms of volumes.

THE WITNESS: That was the 8.317 Bcf. The next number for the 30.59 should be 84,000 Mcf.

MR. JOHNSON: 84,000?

THE WITNESS: I thought I had given you it. That's when you asked your question. Excuse me.

BY MR. ARNETT:

Q. Mr. Smith, yesterday the Commission issued its Order granting application for rehearing vacating portion of Order denying petition for special relief and granting intervention.

Do you have further testimony in light of this Order issued by the Commission?

A. Yes I do. In light of the settlement agreement, which established a negotiated settlement price of 78 cents per Mcf for royalty gas with add-on subject to other adjustments based on Commission action, which I feel is very reasonable in light of today's market price, and in light of the tremendous potential loss that United would face in the event that this case went to court and the leases were lost.

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Approximately 65 percent of all United's gas supply comes from leases within the State of Louisiana. We're curtailing today at 2.5-billion cubic feet per day. Now, we cannot stand to lose one foot of gas. We thought this settlement was in the public interest and the interest of our cus-

tomers and in the interest of the producers and the land owners.

Now, we are prepared to show from the same document I was quoting from, United's latest effective purchase gas adjustment filing, what the latest arm's-length intrastate prices are in this area of South Louisiana, and it will show when I read these numbers the very reasonable price level of 78 cents for the settlement.

The reason these numbers are in our PGA is there is a certain number of sales by producers to United which are now considered by the producer and United and the Federal Power Commission, at least today, to be non-jurisdictional as to the sales of the producer to United. These contracts in the main contain price redetermination provisions based upon the average of the three highest prices in the area, interstate or intra, whatever the highest price.

Therefore, these redeterminations have been triggered and are shown in our PGA and they are, in fact, paying those prices today to these producers.

But the point of this filing is to show what the

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new going price as of July would be in South Louisiana for freely-negotiable gas between a willing buyer and a willing seller in the intrastate market, and I think it would be significant to the Judge and to the Commission to show how much cheaper the settlement price is for gas which, if released, we would be in there trying to buy in this non-jurisdictional phase, at prices well above $1.50.

So, with that I will identify for you particular contracts of United's to producers in excess of area rate, which are approved, as of today, at least, to be non-jurisdictional between the seller of the gas and United. And I will try

to identify for you the page of our PGA so Staff and the other parties could so verify these other numbers.

PRESIDING JUDGE: When you say they are "non-jurisdictional" do you mean — well, are they 60-day emergency purchases?

THE WITNESS: No, sir, these are long-term contracts, Your Honor. The gas is sold to United into a certificated system but the gas physically cannot leave the State of Louisiana, and under various cases, including the case of United, the gas does not go out of the state and is not commingled with gas that goes out of the state, and therefore under today's state of the law and in our rate cases the producers do not file for certificates to make

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such sales at this time.

PRESIDING JUDGE: I see.

THE WITNESS: All right. Exhibit A, Schedule Number 2, page 13 of 104, on line 27 we have a contract with Texaco, Inc. in the Grand Bay Field, South Louisiana, and the effective price is $1.47+, plus meaning some tenths or hundredths of cents.

Page 17 of the same Exhibit A, line 29, producer names Charles T. McCord, Lake Long Field, South Louisiana, and the price is 116.37 cents.

Page 19 of the same schedule, La Pice Field, line 23, Shell Oil Company, $1.12.

La Pice Field, Shell Oil, 108.04 cents.

La Rose Field, Pennzoil Producing, 157.86 cents.

Page 23 of that schedule, Valentine Field, General American Oil Company of Texas, 116.20 cents.

Page 29, Deep Lake Field, Pennzoil Producing, 157.86 cents.

Page 33, line 15, Forest Oil Company, Grand Cheniere, 110.78 cents.

Page 37, line 28, Manchester Field South, Willard E. Walker Producer, 136.30 cents.

Now, those are the list of contracts, based upon price redeterminations in the area that are all in excess of $1.00. I have not attempted to find any between 78 cents

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or the area rate and a dollar, but I think they are significant, that that is the average going price in these areas and I believe the settlement price is more than reasonable in light of the going price.

I might say further United, and I believe there is evidence by the appearance of Michigan, Wisconsin, all pipelines are heavily concerned about market value royalty cases. There are a number of such cases in the courts in the State of Texas, and the law is undergoing some revisions so possibly when it gets to the Supreme Court of the State of Texas — but there are significant claims that have been in interstate commerce for many years, and they may be serious blows to the producers as well as to the pipelines if the outcomes of those are against the pipeline purchasers or the producers.

But under payment of royalty, in Louisiana with the law being different, the possibility of losing the lease is very high and that is a very horrendous possibility to us, and in our opinion it is unwise for either the Staff or the Commission to ignore the realities of the state of the law in these various states.

We're aware of a royalty problem in West Texas. I am a Texas lawyer. I am not a Louisiana lawyer. My personal

opinion is that the Commission is going to lose that case in the Southland litigation under the laws of the State

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of Texas.

I would hope that the Commission and the Staff would support and would look with reason at reasonable settlements of litigation between producers and their royalty owners.

Now, there is a tremendous price disparity, as everyone is aware, between the new intrastate prices and the regulated price today of 52 plus adjustments, and I believe the old, traditional position of being against anything new and innovative to be reasonable in the marketplace, to help the pipelines and the consumers, and the pipelines keep all the gas possible is going to take some rude awakening on the part of all of us, and it's small consolation to United or United's customers to take the position "no, you can't do anything and make it go."

All these cases in litigation in state courts where the outcome is uncertain, the litigation could drag on for years and years, and the Commission may lose. And I would not be surprised to see land owners win a case in the State Courts, take over operation of the wells despite FPC mandate, and at least while litigation is pending there is a chance the landowner could win the lawsuit, could take the gas, despite what the Commission may say, that 7-B is necessary.

The Supreme Court has yet to opine on that, and it might rule in favor of the royalty owner or the land owner.

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So, it's again a small consolidation to win a moral victory in a case like this and put the burden on the producer. The producer might lose the lease.

So, with those remarks, I am prepared to answer further questions on the price issue, Your Honor, or on the prepared testimony.

MR. ARNETT: I tender the Witness for cross examination, Your Honor.

PRESIDING JUDGE: Very well.

Mr. Stevens, do you have any questions?

MR. STEVENS: No, sir.

PRESIDING JUDGE: Mr. Johnson?

MR. JOHNSON: No, Your Honor.

PRESIDING JUDGE: Ms. Province?

MS. PROVINCE: Yes. I have only one question for Mr. Smith.

PRESIDING JUDGE: Very well.

CROSS EXAMINATION

MY MS. PROVINCE:

Q. Mr. Smith, you earlier provided us with a breakdown as to the volumes and rates received.

Do you also have information of what portions of the royalties and gas are subject to the one-eighth royalty payment and which are subject to the one-fourth?

A. We keep records only in total volumes purchased.

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FPC Docket No. RI76-10

Prepared Testimony of
JOHN F. BRUSKOTTER
On Behalf of Shell Oil Company

Q. Please state your name, occupation and educational background.

A. My name is John F. Bruskotter. I am Manager, Natural Gas Marketing, Southern Region, Shell Oil Company. I was graduated from Missouri School of Mines in 1952 with a B.S. degree in Petroleum Engineering.

Q. Please describe your professional experience.

A. I have been employed by Shell Oil Company since graduation. In 1959, I was named Division Reservoir Engineer for Shell's Oklahoma City Division and in 1964, I was assigned to Shell's Exploration and Production Research Center, Houston, Texas as Senior Reservoir Engineer. About one year of this assignment was devoted to research on gas well performance. The results of my work and that of others within my research group was published in the Journal of Petroleum Technology in 1965. In 1966, I was named Staff Reservoir Engineer and was assigned to the New Orleans area. Until 1968, I was responsible for all reservoir engineering in the onshore areas of Louisiana and Mississippi. From mid-1968 until mid-1971, I was Division Petroleum Engineer for the onshore West Division. In June of 1971, I was appointed to my present position as Manager, Natural Gas Marketing, for Shell's Southern Region. The principal producing areas within this Region are the Gulf of Mexico, the east half of the State of Texas, and the States of Louisiana, Mississippi, Alabama and Florida.

Q. To what professional organizations do you belong?

A. I have been active in various professional societies and have served on various industry committees. As a member of the Society of Petroleum Engineers of AIME, I have served on the Continuing Education Committee in New Orleans and was Vice Chairman for Reservoir Engineering on the General Editorial Committee of the Society of Professional Engineers. The industry committees on which I have served include the Oil Scouts Association, Engineering Subcomittee for the Mid-Continent Oil & Gas Association, and the API and AGA Reserve Committees. I am a member of the Society of Petroleum Engineers of AIME, the API and the Gas Men's Association. I am a registered professional engineer in the State of Oklahoma.

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Q. What is the purpose of your testimony in this proceeding.

A. By Order issued August 29, 1975 the Commission ordered a public hearing on Shell's Petition to abandon that portion of its certificate in Docket No. G-5037 and Shell's Rate Schedule No. 202 which is attributable to the mineral or royalty interest listed on Annex A of the Settlement Agreement attached to Shell's Petition in these proceedings, now collectively referred to as "Williams, Inc." The purpose of my testimony in this proceeding is to state Shell's reasons why this Petition should be granted.

Q. Would you state briefly the background of the controversy between Shell and the royalty owners referred to as Williams Inc.

A. Shell sells gas produced from the Gibson Field, Terrebonne Parish, Louisiana, to United under Shell's FPC Rate Schedule No. 202. This sale was originally certificated in Docket No. G-5037 on May 28, 1956 at which time Shell's gas sales contract was designated as FPC Gas Rate Schedule No. 50. Upon the execution and filing of a replacement contract, dated May 1, 1959, the rate schedule designation was changed to No. 202, as noted in the Commission's Order dated June 11, 1959 in Docket No. G-18697 and the Commission's letter dated July 6, 1959.

A portion of the gas sold to United is produced from acreage covered by Mineral Lease dated August 29, 1934 (the 1934 lease) from F. B. Williams Cypress Company, Limited (now Williams, Inc.), to Shell Petroleum Corporation (now Shell) and by Mineral Lease dated July 24, 1952 (the 1952 lease) from Williams, Inc. to certain parties (which lease was assigned to Shell on January 24, 1955). A portion of the acreage covered by the 1934 lease was subleased to Union Producing Company (now Pennzoil Producing Company) on December 29, 1942. Certain portions of the 1934 lease have been unitized and are hereinafter referred to as "Unitized Acreage".

The 1934 lease provides for royalty of the gas production thereunder equal to one-eighth "of the value thereof,

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calculated at the market rate prevailing at the well", and the 1952 lease provides for royalty on the gas production thereunder equal to one-fourth "of the value thereof, calculated at the market price prevailing at the well".

On June 7, 1973, and again on March 27, 1974, Williams, Inc. demanded payment by Shell for gas produced from acreage covered by these leases based on the so-called "market value" clauses contained therein. Further, on June 5, 1974, Williams, Inc. declared both the 1934 lease and the 1952 lease terminated because of Shell's alleged failure to pay the royalty claim by Williams, Inc.

In order to protect its legal rights and interests in these leases, Shell and Pennzoil Producing (against whom similar demands were made by Williams, Inc.) filed a petition on May 24, 1974 in the Civil District Court in the Parish of Orleans, Louisiana (*Shell Oil Company and Pennzoil Producing Company* v. *Williams, Inc., et al.*, Docket No. 578-591) asking issuance of a judgment declaring that Shell and Pennzoil Producing are paying the appropriate royalty. By reconventional demand, Williams, Inc., requested the Court to order cancellation of both the 1934 lease and the 1952 lease effective June 5, 1974 and an accounting for, and payment based on the value of, all minerals produced under such leases since June 5, 1974.

Shell and Williams, Inc. have entered into a Settlement Agreement dated June 18, 1975 (attached to Shell's Petition as Appendix A) which will permit Shell to retain both the 1934 lease and the 1952 lease and continue to sell natural gas to United for the interstate market upon the payment of higher royalties to Williams, Inc. The Settlement Agreement provides that Shell will make such applications to the Federal Power Commission as may be necessary to obtain authorization for the following:

(A) Payment by Shell of royalty on each Mcf produced and sold from Unitized Acreage and under the 1952 lease, equal to one-eighth in the case of the Unitized Acreage and one-fourth in the case of the 1952 lease, of the total of:

(1) the higher of

(a) the base royalty rate, or

(b) the base alternative rate, plus

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(2) 7¢ or the full amount of the Louisiana severance tax, which amount is to be increased as the severance tax of the State of Louisiana is increased, plus

(3) the full amount of federal taxes imposed upon Williams, Inc., plus

(4) any upward or downward adjustment for Btu content of the gas containing more or less than 1,000 Btu per cubic foot, and

pass through to United of the portion of such total which exceeds current royalty payments by Shell to Williams, Inc.

In connection with the above, "base royalty rate" is 78¢/Mcf as of January 1, 1975, increasing 1.5¢/Mcf each January 1st beginning January 1, 1976. "Base alternative rate" is 150 percent of the highest area of national rate permitted or, in the case of deregulation of interstate gas sales, is the average of the three highest prices provided in sales for resale in the South Louisiana area; or

(B) Abandonment of that share of the gas sold under said leases which is attributable to Williams, Inc., royalty interests.

In addition, the Settlement Agreement provides for Shell to deliver royalty gas to Williams, Inc., in the event abandonment authorization is granted pursuant to (B) above, and further to pay Williams, Inc. the sum of the royalty which would have been paid during 1974 if Shell's sales price during such period had been 45¢/Mcf, less royalty actually paid, plus the royalty due if the Commission approves (A) above, all as more fully spelled out in Article II of the Settlement Agreement attached to Shell's Petition as Appendix A.

Q. In your view, why should the Commission permit the Settlement Agreement to become effective by authorizing abandonment of Shell's Certificate and Rate Schedule insofar as it covers the Williams, Inc. royalty interest?

A. I am not an attorney and so cannot comment with any expertise on the legal questions involved. However, the

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fact that a lawsuit is pending to cancel Shell's lease casts a cloud over any further expenditures of any substantial nature on this lease until the questions raised by the litigation are resolved.

Q. Would you comment on the legal risks and their implications for the pipeline purchaser and its consumer customers?

A. My understanding is that Shell's position in Docket No. 573-591 in the Civil District Court in the Parish of New Orleans, Louisiana, is that Shell is required only to pay royalty on the basis of the price which it is permitted to collect by the Federal Power Commission. The Williams, Inc. position is that the "market value" of the gas is some price higher than that permitted to be collected by the Commission and that they are entitled to damages measured by the difference between this royalty figure and the royalty actually paid, and in addition they are entitled to cancellation of Shell's lease by virtue of the alleged failure by Shell to make proper royalty payments.

Q. What would be the impact if Williams, Inc. were to prevail in the lawsuit?

A. If the Settlement Agreement is destroyed because the Commission refuses to grant abandonment of the Williams' interest, Williams, Inc. will claim the "market value" of the gas in Louisiana. In the State Court case, Williams, Inc. has alleged this value to be $1.40. If the Williams, Inc. royalty is calculated on this basis, the royalty would be 35¢ per Mcf on the 1952 lease, and 17.5¢ per Mcf on the 1934 lease. Shell's gas is being sold at two rate levels: the 31.11¢ Mcf ceiling rate for new gas in

Opinion 598 and the 59.88¢ per Mcf ceiling rate authorized by Opinion 699H. In addition to the payment of royalty, Shell's net revenue is further reduced by the 7¢ per Mcf severance tax charged by the State of Louisiana. Therefore, under these circumstances, Shell's operations would have to be severely curtailed and possibly the royalty and tax alone may exceed the revenue recovered.

Q. Why is this?

A. All of the costs of operating, developing and producing an oil and gas lease fall on the working interest or producer, which is Shell in this instance, and none on the royalty owner. Therefore, all of these costs must be

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paid for out of revenue from the lease which is net to Shell. When the normal costs of the operation are considered, it is apparent that Shell will be unable to make further substantial expenditures to prevent early depletion of this lease.

Q. Has the risk of the State Court suit delayed any development on these leases?

A. Yes, very definitely. Shell has planned to drill a well on the 1934 lease, at a location in the N/2 SE/4 Section 30,

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Township 17 South, Range 15 East, Terrebonne Parish. The well was approved for drilling by Shell's Management on June 19, 1973. When Williams, Inc. made their demands, which later culminated in the State litigation, this well was indefinitely postponed. The location has been prepared, and if, as and when the cloud of this litigation is removed, Shell will reevaluate the feasibility of drilling this well.

Q. What would be the result if Williams, Inc. prevailed in canceling the lease for failure to properly pay royalty?

A. Shell would be in a position of losing its entire investment in this lease through no fault of its own, because the Commission would not permit it to collect a price for its gas which is equal to the market value thereof, and would not approve a settlement which would have eliminated the problem.

Q. What are the damages claimed by Williams, Inc. against Shell for underpayment of royalty?

A. The Williams are claiming damages for past underpayment of royalties in the amount $197,689.49 through April 30, 1975.

Q. From the standpoint of the consumer, what would be the effect of such a decision by the Louisiana Court?

A. It is my understanding that the Williams, Inc. take the position that, should they prevail in the lawsuit, they will not be bound by Shell's contract to sell the gas to United, or by the Certificate of Public Convenience and Necessity issued by the Commission. They will therefore attempt to sell this gas on the intrastate market.

Q. Does the pipeline purchaser and its consumer customers have any recourse against this position?

A. It is my understanding that in Opinion No. 737, El Paso Natural Gas Company, Docket No. CP75-209, the Commission has held that a certificate of public convenience and necessity requires the continuation of a sale in the interstate market even after the termination of the lease. It is also my understanding that appeals are pending from this decision.

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in the Court of Appeals.

Q. In other words, if the Settlement Agreement is destroyed by the refusal of the Commission to grant abandonment as to the royalty interests, the customers of United stand the risk of being deprived of 100 percent of the gas now being sold under Shell's Rate Schedule No. 202?

A. That is correct.

Q. Does that complete your testimony.

A. Yes, it does.

* * * *

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MR. JOHNSON: Maybe we could just go off the record for a moment?

PRESIDING JUDGE: Very well.

Off the record.

(A discussion was held off the record.)

PRESIDING JUDGE: Back on the record.

We have been discussing problems of time, and believe with an expedited proceeding here, and problems of affording Shell whatever opportunity it thinks it needs to file additional cost data if it feels it needs such an opportunity.

Shell has apparently just seen the September 22nd Order this morning, and I don't want to be in a position of foreclosing Shell from producing whatever additional cost data it feels it has to produce.

Now, Pennzoil has expressed the view that it has presented its case and wishes the proceedings to be expedited as much as possible and is shooting for a briefing date of October the 10th, at least for the initial briefs, as I understand it.

MR. HACKERMAN: Yes, Your Honor.

PRESIDING JUDGE: Staff has expressed a view that if Shell is going to produce additional cost data that it will want some decent opportunity to examine and consider it and perhaps rebut it.

MR. JOHNSON: If Your Honor please, we are in a

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quandary for several reasons. The Commission's initial Order said something about overall costs, without any explanation. Staff has made an indication here today that they feel that some additional cost data is required.

I would like to direct a question to the Staff through Your Honor about what additional cost data they believe to be required.

PRESIDING JUDGE: Can you respond to that, Ms. Province?

MS. PROVINCE: Yes, Your Honor. We would need the unit cost of gas based on the actual cost associated with the properties involved.

MR. JOHNSON: Well, I could ask further questions but I don't know whether it would be useful, Your Honor. I think we'll just have to take this request under advisement.

I would request that Your Honor allow us time within which to do that, whatever Your Honor feels is reasonable. We indicated off the record that Mr. Bruskotter has other commitments for all of next week.

PRESIDING JUDGE: Well, I'm prepared to sit today and tomorrow to try to conclude this case. I don't think that will be possible if you're going to have to go back and develop some cost figures.

MR. JOHNSON: That's correct, Your Honor. All of our cost records are, of course, in New Orleans. There's no way

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submission of whatever additional cost data Shell wishes to adduce in support of its position. That should be done in writing and should be in the hands of all the parties and the Commission Staff and myself by October the 2nd.

MR. JOHNSON: Your Honor, the mails are awfully uncertain. Could that be a mailing date?

PRESIDING JUDGE: Well, that's the problem with tying it in with the hearing date. I want to set a hearing date.

MR. JOHNSON: Oh, I see.

PRESIDING JUDGE: Well, I would just have to set it on the 8th in order to accommodate Commission Staff and put over my other cases starting on the 7th.

I will — let me strike the October 2nd date and put that the 3rd to give you an extra day.

MR. JOHNSON: Thank you, Your Honor.

PRESIDING JUDGE: And then we will resume this hearing on the 8th unless — well, we'll resume this hearing on the 8th then.

MR. JOHNSON: Your Honor, could I —

PRESIDING JUDGE: Let me — referring to the suggestion you put forth before, Mr. Johnson, that if you advise that you do not wish to submit any additional cost data it may not be necessary to hold another hearing in this matter.

MR. JOHNSON: Yes, Your Honor. We will undertake to advise you on the same date, the 3rd, if we feel that we

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EXHIBIT 2 (ADG-2)

Williams, Inc.
Whitney Building
New Orleans 70130

March 27, 1974

Certified Mail —

Return Receipt Requested

Shell Oil Company
P. O. Box 60193
New Orleans, Louisiana 70160

Pennzoil Company
900 Southwest Tower
Houston, Texas 77002
Attention: G. Bruce Mallum, Esq.

Pennzoil Producing Company
533 Westheimer, Suite 950
Houston, Texas 77027
Attention: Mr. J. T. Goodwyn, Jr.

Re: (1) Mineral Lease dated August 29, 1934 Between F. B. Williams Cypress Company, Limited (now Williams, Inc.), Lessor, and Shell Petroleum Corporation (now Shell Oil Company), Lessee

and

(2) Oil, Gas and Mineral Lease dated July 24, 1952, between Williams, Inc. and Mrs. Delphine C. Williams, et al., assigned to Shell Oil Company on January 4, 1955

Gibson Field — T17S-R15E
Terrebonne Parish, Louisiana

Gentlemen:

We submit herewith formal demand on behalf of Williams, Inc. as lessor and partial royalty owner and on behalf of the remaining royalty owners named on the attached schedule that the addressees comply with the obligations under the lease provisions under the captioned lease dated August 29, 1934 ("the 1934 lease") to pay to lessor or its assignees a gas royalty of "one-eighth (1/8) of the *value* thereof, calculated at the *market rate* prevailing at the well. . . ." We further make formal demand on behalf of Williams, Inc. as lessor and royalty owner that Shell Oil Company, as assignee of the captioned Oil, Gas and Mineral Lease dated July 24, 1952 ("the 1952 lease") comply with the lease provisions to pay the lessor a gas royalty of "one-fourth (1/4) of the value thereof, calculated at the market rate prevailing at the well. . . ."

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Our investigation reflects that the value calculated at the market rate prevailing at the well as applied to recent production for purposes of royalty calculation should be no less than the following amounts for the following periods of time:

Period	Price Per MCF
October 1, 1971 — March 2, 1973	35 cents
March 3, 1973 — September 30, 1973	45 cents
October 1, 1973 — November 8, 1973	54 cents
November 9, 1973 — December 31, 1973	70 cents

We further demand that the current price of 70 cents per Mcf be applied for purposes of computation of royalty from

January 1, 1974 through the current period. We have calculated the underpayment of royalties due to the royalty owners reflected on the annexed schedule aggregates underpayment of royalties through December 31, 1973 from both leases of no less than $1,055,204.62, being $912,276.80 owed by Pennzoil Producing Co. and $142,927.82 by Shell Oil Company.

Williams, Inc. in its capacity as successor to all rights of the original lessor under the 1934 lease and as lessor under the 1952 lease further demands cancellation and termination of the leases in view of the failure of the lessee and its related parties to comply with the obligations under the leases with respect to the payment of proper royalties to the proper royalty owners.

We withdraw herewith the demand made in our letter of June 7, 1973 on behalf of Williams, Inc. in order to avoid any confusion. We make the foregoing demand on behalf of Williams, Inc. and on owners of royalty under the 1934 lease, who have authorized Williams, Inc. to represent them in asserting their demands for royalty payments.

Yours very truly,

Williams, Inc.

By: FRANK B. WILLIAMS
Frank B. Williams

* * * *

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EXHIBIT 4 (ADG-4)
CIVIL DISTRICT COURT
IN AND FOR
THE PARISH OF ORLEANS
STATE OF LOUISIANA

NO. .... DIV. .... DOCKET ....

Shell Oil Company
and
Pennzoil Producing Company
vs.
Williams, Inc., et al

FILED: ....
Deputy Clerk

PETITION FOR TEMPORARY RESTRAINING ORDER, PRELIMINARY AND PERMANENT INJUNCTION, AND DECLARATORY JUDGMENT

The petition of:

(1) SHELL OIL COMPANY, a corporation organized under the laws of the State of Delaware, but qualified to do business in the State of Louisiana, which maintains its registered office in the State of Louisiana at 1300 Hibernia Building, New Orleans, Louisiana, (hereinafter referred to as "Shell"); and

(2) PENNZOIL PRODUCING COMPANY, a corporation organized under the laws of the State of Delaware, but qualified to do business in the State of Louisiana, which maintains its registered office in the State of Louisiana at 1300 Hibernia Building, New Orleans, Louisiana, (hereinafter referred to as "Pennzoil"), respectfully represents that:

I.

Shell is an integrated oil company engaged in the production and refining of all forms of petroleum and hydrocarbons and is the successor in interest to its predecessors, Shell Petroleum Corporation and Shell Oil Company, Incorporated.

II.

Pennzoil is a corporation engaged in the exploration, production and development of oil and gas properties and mineral prospects and is the successor in interest to its predecessor, Union Producing Company.

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III.

The principal defendant herein, WILLIAMS, INC., is a corporation organized under the laws of the State of Delaware, but qualified to do business in the State of Louisiana, which maintains its registered office in the State of Louisiana and principal business establishment at 1323 Whitney Building, New Orleans, Louisiana. Williams, Inc. is the successor in interest to its predecessor, F. B. Williams Cypress Company, Limited.

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VI.

The parties named in Articles III and IV collectively and individually own beneficial interests in the oil, gas and mineral leases hereinafter more particularly described and as such they are now, and they and their predecessors for many years past have been, the recipients of regular royalty payments representing a portion of the proceeds of mineral production from the Gibson Field in the Parish of Terrebonne.

VII.

By instrument dated August 29, 1934, F. B. Williams Cypress Company, Limited and C. S. Williams, Trustee, as lessors, granted to Shell Petroleum Corporation, as lessee, an oil, gas and mineral lease, designated as No. 30321, formerly No. L 3357, (hereinafter referred to as the "1934 Williams Lease"), registered in Conveyance Book 103, folio 274 of the records of the Parish of Terrebonne, which embraced 61,442 acres situated in five South Louisiana parishes and provided for a five year primary term to commence with a selection date set forth therein. The 1934 Williams Lease also stipulated that on or before August 29, 1935, the original selection date, the lessee should designate or select areas suitable for mineral development as to which drilling operations should be commenced or rentals paid in accordance with the lease

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terms; that such areas should be treated as development units thereafter; and that the remainder of the leased property was subject to be released by the lessee. By agreement of the parties the original selection date was extended to March 1, 1937, and prior thereto the lessee selected 3,508.81 acres in the Parish of Terrebonne, known as Area "K", which forms a portion of the Gibson Field in said parish. Thereafter, the 1934 Williams Lease was maintained in force and effect according to its terms and on the 13th day of October, 1937, a producing oil well designated as Shell Pelican No. 2 was completed on Area "K". The lease has since been continuously maintained in force and effect by production, and the defendants herein and their predecessors have regularly received and accepted royalty payments made to them conformably to the provisions of the lease.

VIII.

Paragraph 4 of the 1934 Williams Lease (a copy whereof is annexed hereto and made part hereof as Exhibit A), stipulates in part that: "Lessee agrees as to royalties: * * * to pay Lessor for gas and/or casinghead gas produced and saved by Lessee from the land hereby leased (a) *one-eighth* (1/8) *of the value thereof, calculated at the market rate prevailing at the well,* * * *".

IX.

Shell Petroleum Corporation, as lessee under the 1934 Williams Lease, had stringent development obligations, yet was without a market for any gas it might produce and had no facilities to transport such gas to a market, if any had existed. Consequently, Shell was obliged to arrange for the development

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of the leased acreage for gas and the marketing of any gas that might be thereby produced. By instrument dated December 24, 1941, styled "Gibson Area Agreement" (a copy whereof is annexed hereto and made part hereof as Exhibit B) Shell Oil Company, Incorporated, successor to Shell Petroleum Corporation, and Union Producing Company (hereinafter referred to as "Union"), predecessor to Pennzoil, agreed that Union would drill two gas wells on acreage located in Township 17 South, Range 15 East, in the Parish of Terrebonne, lying within the area selected under the 1934 Williams Lease. These wells were to be drilled pursuant to the explicit agreement between said parties that Union would have such wells connected to a 10 inch pipe line which was to be constructed by United Gas Pipe Line Company (hereinafter referred to as "United") under a certain gas sales contract between Union and United and to the further agreement by Union to purchase

said two wells from Shell Oil Company, Incorporated, if they were completed as gas wells with a capability of producing gas in paying quantities. At that time United operated the only pipe line in the area and thus provided the only possible market for such gas. The Gibson Area Agreement further took express cognizance of the fact that under the aforesaid gas sale contract between Union and United dated December 23, 1941, (hereinafter referred to as the "1941 Gas Sale Contract", a copy whereof is annexed hereto and made part hereof as Exhibit C) gas produced by Union in stipulated quantities from the Shell leases (including the 1934 Williams Lease) in the Gibson Field, would be sold and delivered to United by Union, as sublessee of Shell Oil Company, Incorporated. Under the Gibson Area Agreement Shell Oil Company, Incorporated, was to transfer its gas rights to Union subject to the reservation of an overriding royalty of 1/8th of 8/8ths of any distillate, condensate and other liquid hydrocarbons produced from gas wells, with such royalty to be increased to 3/16ths of 8/8ths after the fourth year of the first gas deliveries, an overriding royalty on

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gasoline extracted from gas of 3/32nds of 8/8ths thereof, and an overriding royalty on gas of 1/8th of the value at the well of gas produced from gas wells, *to be increased to 3/16th of the value at the well of gas produced from gas wells after the fourth year of the first gas deliveries.* For the purpose of computing the reserved overriding royalty, the Gibson Area Agreement further provided that the value of the gas was to be the price to be received by Union from United under the 1941 Gas Sale Contract; and after the termination of said contract, the value of such gas was to be that agreed upon by the parties from time to time "determined by the prevailing market price of gas at the

well in the Central part of South Louisiana Area". Finally, the Gibson Area Agreement provided that Shell Oil Company, Incorporated, reserved the right to purchase from Union any gas produced from the affected leases for production of oil upon payment of a price "equal to the market value of said gas at the time taken as fixed and established under the provisions" set forth above, but subject to a maximum limit of 500 million cubic feet during any one calendar year.

X.

By a sublease (hereinafter referred to as "Sublease") dated December 29, 1942, effective as of December 24, 1941, registered in Conveyance Book 134, folio 463, of the records of the Parish of Terrebonne (a copy of which Sublease is annexed hereto and made part hereof as Exhibit D) Shell Oil Company, Incorporated, subleased to Union its rights in the gas and certain other liquid hydrocarbons produced and to be produced under the 1934 Williams Lease and other leases by different lessors in the Gibson Field, subject to the reservation of the overriding royalties set forth in Article IX. The Sublease was approved by Williams, Inc. on its own behalf and on behalf of its royalty distributees by a letter dated

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December 30, 1941, (a copy of which letter is annexed hereto and made part hereof as Exhibit E). Thereafter by letter dated January 21, 1943 (a copy of which letter is annexed hereto and made part hereof as Exhibit F) the royalty distributees took cognizance of Williams, Inc.'s approval of the Sublease and designated Williams, Inc. to receive for itself and for the other named defendants herein, or their predecessors in title, as royalty distributees, payment of all gas royalties and other payments under the 1934 Williams Lease.

XI.

The parties to the 1941 Gas Sale Contract took cognizance of the fact that United operated a pipe line from the Lirette Field and from other fields in the Parish of Terrebonne to a point near Covington, Louisiana, and that Union contemplated acquisition of gas rights from Shell Oil Company, Incorporated, in the Gibson Field pursuant to an obligation to drill additional wells in the Gibson Field in order to enable Union to supply a portion of United's requirements. Under the terms of the 1941 Gas Sale Contract, Union agreed to sell and United agreed to buy "merchantable gas which may be produced from the lands and leaseholds under which Seller (i.e., Union) owns or shall hereafter own, and from the lands and leaseholds of others from whom Seller (i.e., Union) is now purchasing or may hereafter purchase gas in the Gibson Field in Terrebonne Parish, Louisiana", and Buyer (i.e., United) was to "have the right and privilege from time to time, at any time during the term of this agreement, of purchasing all of the merchantable gas produced from said lands and leaseholds • • •".

XII.

The 1941 Gas Sale Contract stipulated for the payment by United to Union of a price of three cents per thousand cubic feet ("MCF") of gas plus a tax allowance from the date of first delivery to June 30, 1945, and a minimum price of 4 cents plus tax allowance from July 1, 1945, to June 30, 1950, but determinable according to a stipulated formula, which was

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dependent upon a weighted average price for said gas received by United's utility customers. Pursuant to an agreement between Union and United dated March 18, 1949,

the contract term was extended to June 30, 1960; oil well gas (i.e., gas produced along with crude oil from an oil well) was included within the gas to be taken by United under the 1941 Gas Sale Contract, and the price of said gas was increased to 10 cents per MCF, plus one-half of new or additional taxes imposed by law upon Union after June 30, 1950.

XIII.

On or about October 30, 1959, Union and United entered into a second gas sales contract (No. 2679, hereinafter referred to as the "1959 Gas Sale Contract", a copy whereof is annexed hereto and made part hereof as Exhibit G) which became effective by its terms on November 1, 1959, which expressly superseded the 1941 Gas Sale Contract, and which further provided that the contract term would expire on November 1, 1979. The 1959 Gas Sale Contract required United to take or pay for, during each contract year, quantities of gas at least equal to an annual minimum quantity defined as 36.5 million cubic feet of gas per contract year for each billion cubic feet of Union's gas reserves (i.e., the estimated total quantity of recoverable gas owned by Union and contained in its reservoirs underlying the subject leaseholds). The 1959 Gas Sale Contract further established the price payable for gas sold and delivered thereunder by Union to United at the following rates: 21.25 cents per MCF until May 1, 1964; 22.25 cents thereafter until May 1, 1969; 23.25 cents thereafter until May 1, 1974; and 24.25 cents thereafter until November 1, 1979, plus a tax reimbursement in connection therewith, with the basic price for the periods from May 1, 1969, through November 1, 1979, subject to redetermination on the basis of an average of the three highest unit prices being paid within a six parish area under contracts between bona fide gas pipe line companies and producers. The 1959 Gas Sale Contract stipulated that it was made subject to any present and

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future valid orders, rules, and regulations of any federal or state regulatory body having jurisdiction.

XIV.

Under the rationale of *Phillips Petroleum Co.* v. *Wisconsin,* 347 U.S. 672 [1954] decided on June 7, 1954, the Supreme Court of the United States recognized the power of the Federal Power Commission to regulate the price to be charged at the wellhead by gas companies to interstate pipe lines for resale in interstate commerce. Accordingly, the price charged by Union to United for gas sold after June 7, 1954, was governed by regulation of the Federal Power Commission, rather than by the applicable provision of the 1941 and 1959 Gas Sale Contract.

XV.

By an instrument dated July 24, 1952, registered in Conveyance Book 217, folio 18, of the records of the Parish of Terrebonne, Williams, Inc. granted an oil, gas and mineral lease (No. L-12327, hereinafter referred to as the 1952 Williams Lease, a copy whereof is annexed hereto and made part hereof as Exhibit H) covering 20 acres out of Section 36, T 17 S, R 15 E, Terrebonne Parish, unto Mrs. Delphine C. Williams, Frank B. Williams, Mrs. Elizabeth Williams Zorthian, Mrs. Leila Moore Williams, L. Kemper Williams, Mrs. Katharine Williams Tremaine, Laurence H. Williams, and Mrs. Lucille Williams Mayfield, providing for a five year primary term and royalties of one-sixth on oil and gas. The aforenamed lessees assigned the 1952 Williams Lease to Shell, and the said lease was amended by an agreement between the lessees and Shell, dated January 24, 1955, to increase the royalty fraction stipulated to be paid to the original lessees in said lease from an undivided one-sixth to an undivided one-fourth. The royalty

fraction as thus increased was to be applied, with respect to gas, to *"the value thereof, calculated at the market price prevailing at the well"*.

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By an agreement (hereinafter referred to as the "1944 Shell Gas Sale Contract", a copy whereof is annexed hereto and made part hereof as Exhibit I) dated October 5, 1944, Shell Oil Company, Incorporated, and Barnsdall Oil Company agreed to sell and United agreed to buy "merchantable gas which may be produced from the lands and leaseholds which Seller (i.e., Shell Oil Company, Incorporated, and Barnsdall Oil Company) owns and shall hereafter own and from the lands and leaseholds of others from whom Seller is now purchasing or may hereafter purchase gas in the Gibson Field" and Buyer (i.e., United) was to "have the right and privilege from time to time, at any time during the term of this agreement, of purchasing all of the merchantable gas produced from said lands and leaseholds . . .",

XVII.

The 1944 Shell Gas Sale Contract stipulated for the payment by United to Shell Oil Company, Incorporated, and Barnsdall Oil Company of a price of 3 cents per MCF of gas plus a tax allowance from the date of first delivery to June 30, 1945, and a minimum price of 4 cents plus tax allowance from July 1, 1945, to June 30, 1950, but determinable according to a stipulated formula which was dependent upon a weighted average price for said gas received by United's utility customers. Gas produced in connection with the development of oil wells under the 1934 Williams Lease was sold pursuant to the 1944 Shell Gas Sale Contract but in order to specifically so provide Shell Oil Company, Incorporated, and Barnsdall Oil Company amended the 1944 Shell Gas Sale Contract by agreement

dated March 1, 1949, pursuant to which the contract term was extended to June 30, 1960 and pursuant to which the parties thereto agreed that "Oil Well Gas" or casing-head gas could be delivered in order to supply a portion of the requirements of United's Lirette-Mississippi Pipe Line under the terms of the 1944 Shell Gas Sale Contract; similarly,

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the price to be paid by United to Shell Oil Company, Incorporated, and Barnsdall Oil Company was increased to 10 cents per MCF plus one-half of any additional taxes imposed by law after June 30, 1950.

XVIII.

On or about May 1, 1959, Shell and United entered into a second gas sales contract (hereinafter referred to as the "1959 Shell Gas Sale Contract", a copy whereof is annexed hereto and made part hereof as Exhibit J) which became effective by its terms on May 1, 1959, which expressly superseded the 1944 Shell Gas Sale Contract and further provided that the contract term would expire on April 30, 1979. The 1959 Shell Gas Sale Contract required United to take or pay for, "during each contract year (from a portion of Shell's natural gas production in the Gibson Field including, with production from other sources, natural gas produced upon the twenty acre tract affected by the 1952 Williams Lease) quantities of gas at least equal to an annual minimum quantity defined as 36.5 million cubic feet of gas per contract year for each billion cubic feet of Shell's gas reserves. The 1959 Shell Gas Sale Contract further established the price payable for gas sold and delivered thereunder by Shell to United at the following rates: 21.25 cents per MCF until May 1, 1964; 22.25 cents thereafter until May 1, 1969; 23.25 cents thereafter until

May 1, 1974, and 24.25 cents thereafter until April 30, 1979, plus a tax reimbursement in connection therewith, with the basic price for the periods from May 1, 1969 through April 30, 1979 subject to redetermination on the basis of an average of the three highest unit prices being paid within a six parish area under contract between bona fide gas pipe line customers and producers. The 1959 Shell Gas Sale Contract stipulated that it was made subject to any present and future valid orders, rules, and regulations of any federal or state regulatory body having jurisdiction.

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XIX.

As stated hereinabove, United was the purchaser of all the natural gas produced by Pennzoil and its predecessor, Union, under the 1934 Williams Lease, and said gas was received and transported by United in its Lirette-Mississippi, interstate pipe line pursuant to the 1941 Gas Sale Contract. Similarly, gas produced by Shell under the 1934 and 1952 Williams Leases was sold by Shell as a portion of its Gibson Field production to United and likewise was received and transported by United in its Lirette-Mississippi, interstate system in consequence whereof as a matter of fact and law all of said gas produced by Pennzoil and Shell under the 1934 and 1952 Williams Leases was dedicated to United's interstate system. Under the rationale of *Phillips Petroleum Co.* v. *Wisconsin,* 347 U.S. 672 (1954), decided by the Supreme Court of the United States on June 7, 1954, gas producing companies engaged in the sale of gas to interstate pipe line companies for resale were classified as natural gas companies within the meaning of the Natural Gas Act; and accordingly the Federal Power Commission, under the supremecy clause of the United States Constitution, was invested with inherent power and jurisdiction to regulate the price to be charged at the well-

head for gas sold by natural gas companies to interstate pipe lines for resale in interstate commerce. Accordingly, the price for old gas sold by Pennzoil and Shell and their predecessors after June 7, 1954, was governed by the regulations of the Federal Power Commission rather than by the applicable provisions of the gas sales contracts in effect at that time.

XX.

The sale of natural gas which gives rise to the controversy described herein has been subjected to the regulatory control of the Federal Power Commission under the terms of the Natural Gas Act, 15 U.S.C., §§717-717W (1938) and the rationale of the *Phillips* decision, *supra.* Following the *Phillips*

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decision, the Federal Power Commission issued "grandfather" certificates covering sales of gas in existence on June 7, 1954, allowing prices collected on that date to continue to be collected. On or about the 28th day of September, 1960, the Federal Power Commission established "guideline" prices for the purpose of controlling wellhead prices of natural gas. *Statement of General Policy No. 61-1, 24 FPC 818 (1960).* During this period, and prior to the advent of area rate regulation, the Federal Power Commission allowed producers to collect prices based on the applicable "guideline" price on individual company bases adjudicated before the Commission. During this period, many natural gas producing companies entered settlements involving their wellhead prices of natural gas. On or about the 25th day of September, 1968, the Federal Power Commission issued its first area rate decision for the Southern Louisiana Area. Opinion No. 546, 40 FPC 530 (1968). Shortly thereafter, on or about the 27th day of October,

1970, the Federal Power Commission authorized producers to collect, subject to refund, rates in excess of those established in Opinion No. 546. Order No. 413, 44 FPC 1316 (1970). On or about July 16, 1971, the Federal Power Commission issued its second area rate decision for the Southern Louisiana Area. Opinion No. 598, 46 FPC 86 (1971). The ceiling prices established in Opinion No. 598 are presently in effect for the Southern Louisiana Area, although this opinion is being challenged on judicial review and therefore is not final. *Mobil Oil Corp.* v. *F.P.C.*, No. 73-437, et al. (U.S. Sup. Ct.). Accordingly, from June 7, 1954 through the present date, the gas produced, sold and delivered from the 1934 Williams Lease and the 1952 Williams Lease has been subject to Federal Power Commission regulation, and Pennzoil, Shell, and their predecessors in interest from the inception of production under such leases have continually sold and delivered the natural gas produced therefrom to United's interstate pipe line system for resale in interstate commerce.

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Thus, at all times subsequent to the inception of regulations by the Federal Power Commission of the wellhead price of natural gas transported and sold in interstate commerce, the natural gas produced by Pennzoil and Shell and their predecessors, under the 1934 Williams Lease and the 1952 Williams Lease, has been "jurisdictional gas" subject to regulation and control as to price by the Federal Power Commission.

XXI.

As stated hereinabove, when initial gas production was established under the 1934 Williams Lease there was no pipe line or gas gathering system established and in operation in the Gibson Field. Consequently, a motivating cause for the execution of the Sublease affecting gas rights thereunder was to obtain an assured market for the gas reserves to be developed under the 1934 Williams Lease. The prices stipulated in the 1941 Gas Sale Contract between Union and United constituted the best and in fact the only "market price" obtainable for such gas at that time. Moreover, such gas was originally dedicated for sale and transportation in interstate commerce and since 1954 has been subject to regulation and control as to price by the Federal Power Commission. From 1954 until the present date Williams, Inc., on its own behalf and as agent for the other defendants herein or their predecessors, has been paid royalties computed conformably to Federal Power Commission regulated prices, which have been increased from time to time since the inception of such regulation pursuant to appropriate orders of the Federal Power Commission; and defendants have been the beneficiaries of such price increases.

XXII.

By letter agreements dated May 23, 1973, and May 24, 1973, (copies whereof are annexed hereto and made part hereof as Exhibits K and L) Shell and Pennzoil, respectively, amended the 1959 Shell and Pennzoil Gas Sale Contracts to add a provision that if the Area Rate (i.e., the applicable rate by order of the Federal Power Commission for gas produced from the leasehold area) should be greater than the contract price

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including tax reimbursement and Btu content adjustment, then United should pay Pennzoil and Shell an amount equal to the Area Rate. The agreement between Shell and United likewise increased the base price for the last two periods

of adjustment from 23.25 and 24.25 cents to 26.05 and 27.05 cents, respectively. Both letters added a clause providing that in the event that the Federal Power Commission ceases to regulate the price of "jurisdictional" natural gas produced in the Gibson Field and sold in interstate commerce, the price to be paid Pennzoil and United shall be based upon a fraction taking into consideration the highest prices paid to the South Louisiana area.

XXIII.

Notwithstanding the foregoing, by letter dated March 27, 1974, (hereinafter referred to as the "Williams Letter", a copy whereof is annexed hereto and made part hereof as Exhibit M) addressed to petitioners and Pennzoil Company, Williams, Inc. on its own behalf and on behalf of the other defendants herein asserted a formal demand for $1,055,204.62 for gas royalties allegedly due under the 1934 Williams Lease and the 1952 Williams Lease computed at unit prices per MCF for various periods between October 1, 1971, and December 31, 1973, from 35 cents to 70 cents, and 70 cents after January 1, 1974. The total demand consisted of $912,276.80 claimed to be due by Pennzoil and $142,927.82 claimed to be due by Shell. The Williams Letter further demanded cancellation and termination of the 1934 Williams Lease and the 1952 Williams Lease.

XXIV.

Paragraph 12 of the 1934 Williams Lease provides in part that:

> "In the event Lessor considers that Lessee has not complied with all its obligations hereunder, both express and implied, Lessor shall notify Lessee in writing, setting out specifically in what respects Lessee has breached this contract. Lessee shall then have sixty (60) days after

> receipt of said notice within which to meet or commence to meet all or any part of the breaches alleged by Lessor. The service of said notice shall be precedent to the bringing of any action by Lessor on said lease for any cause. Neither the service of said notice nor the doing of any acts by Lessee aimed to meet all or any of the alleged breaches shall be deemed an admission or presumption that Lessee has failed to perform all its obligations hereunder."

and paragraph 5 of the 1952 Williams Lease provides in part that:

> "After production of oil, gas or other minerals in paying quantities, no default or breach of any expressed or implied obligation of Lessee shall work a forfeiture or cancellation of this lease unless and until Lessee shall have been notified in writing of the facts relied upon by Lessor as constituting a breach and Lessee given sixty (60) days after receipt of such notice to comply therewith."

The sixty-day period set forth in both lease provisions has not yet expired.

XXV.

Both petitioners and defendants agree that the measure for determining the royalty obligation due is governed by the phrases "one-eighth (1/8) of the value thereof, calculated at the *market rate* prevailing at the well" and "one-fourth (1/4) of the value thereof, calculated at the *market price* prevailing at the well" contained in the 1934 and 1952 Williams Leases, respectively. Defendants contend that the "market rate" or "market price" for the years in question is as follows:

Period	Price Per MCF
October 1, 1971 — March 2, 1973	35 cents
March 3, 1973 — September 30, 1973	45 cents
October 1, 1973 — November 8, 1973	54 cents
November 9, 1973 to date	70 cents

Defendants, however, set forth no theoretical basis for their conclusion. Petitioners contend, on the other hand, that the proper measure of the "market rate" or "market price" for pur-

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poses of determining the royalties due under the 1934 and 1952 Williams Leases is no greater than the price permitted pursuant to the regulations of the Federal Power Commission.

XXVI.

Not only did Pennzoil and Shell and their predecessors diligently discharge their lease obligations to market the natural gas produced in the Gibson Field but they also insured the best price obtainable for such gas by including in their contracts price escalation clauses to be based in one instance on the highest price received by United's utilities customers and in the other on an average of the three highest unit prices being paid within a six parish area of South Louisiana under contracts between bona fide gas pipe line companies and producers. Had not the Federal Power Commission asserted jurisdiction over the gas produced in the Gibson Field, the price obtainable for such gas and therefore the price upon which royalty under the 1934 and 1952 Williams Leases would be determinable would have been the highest obtainable in the market for

such natural gas produced under the aforesaid leases at any point in time. Nonetheless, the implications of the 1954 *Phillips* decision, *supra,* and the subsequent area rate regulations superseded the contract provisions and therefore not only govern the price received by Pennzoil and Shell but constitute the "market rate" or "market price" for purposes of determining royalty under both the 1934 and the 1952 Williams Leases.

XXVII.

As alleged in paragraph X defendants either approved or took cognizance of the approval of the assignment or sublease of the 1934 Williams Lease to Union and were aware that natural gas produced thereunder was being sold and was to be sold in the interstate market.

XXVIII.

Gas sold under the 1934 and 1952 Williams Leases to United was thereby dedicated to the interstate market and can

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be sold in no other market absent abandonment proceedings before the Federal Power Commission. Such gas is thus salable for all practical purposes only in the interstate market and any comparison of "market rate" or "market price" must be restricted to the interstate market for the Gibson Field; in that respect the "market rate" or "market price" is the regulated rate established by the Federal Power Commission for the Gibson Field. Pennzoil, Shell and the defendants have continuously been paid on the basis of the regulated price.

XXIX.

Natural gas, unlike petroleum or liquid hydrocarbons, has historically been sold under long term contracts primar-

ily because of the extensive capital expenditures necessary to develop processing plants, gathering systems and pipe lines. In order to assure a fair rate of return on investment, prices specified in gas contracts, even those containing escalation clauses, must be fairly ascertainable at the inception of such contracts. Since the amount of royalty payable to lessors is also an important element in pricing, it is imperative to the economic viability of the natural gas industry and inherent in the history of long term natural gas sales contracts that the measure of the royalty due (i.e. "market rate" or "market price" in this instance) be governed by the prevailing "market price" or "market rate" at the time when gas developed pursuant to a mineral lease is initially dedicated to a gas sales contract.

XXX.

If at the time gas produced under a mineral lease is initially sold the price specified in the contract for the sale of such gas is equal to or greater than the then prevailing "market rate" or "market price" at the wellhead, the contract provisions as to price should govern.

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XXXI.

Gas produced under the 1934 and 1952 Williams Leases is sold to the interstate market and in each instance in which such gas has been sold Shell, Pennzoil and their predecessors obtained the highest "market rate" or "market price" obtainable at that moment in time. Thus, the pricing provisions, including escalation provisions, in each such gas sale contract should govern the measure of the royalty obligation due the defendants.

XXXII.

Petitioners have at all times remitted royalties to defendants and their predecessors on the basis of the proper measure of that obligation and for that reason request a declaration by this Honorable Court that petitioners' interpretaticn of the phrases "market rate" and "market price" in the subject leases is correct, that petitioners have properly discharged their royalty obligations to defendants, and that the 1934 Williams Lease and the 1952 Williams Lease are still in force and effect, notwithstanding the demands made by defendants in the Williams Letter.

XXXIII.

In the event that the Court should conclude that petitioners' interpretation of the phrases "market rate" and "market price" in the subject leases is incorrect and that as a result petitioners have not remitted to defendants royalties measured on a proper basis, which petitioners deny, nevertheless petitioners are entitled to remit such royalties for any periods in question in compliance with the final judgment entered in these proceedings in order to preserve in force and effect the 1934 Williams Lease and the 1952 Williams Lease; petitioners are amply solvent and would be able to make such payment, and petitioners, in the alternative, request a declaration by this Honorable Court that, upon such payment, such leases continue in force and effect, notwithstanding the demands made by defendants in the Williams Letter.

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XXXIV.

Petitioners aver that a good faith justiciable controversy exists over the measure of their royalty obligations to defendants; that for that reason the mineral leases in

question should not be cancelled; that cancellation of the 1934 and 1952 Williams Leases would result in irreparable harm, damage and loss to petitioners for such cancellation would result in a loss of leasehold interest and natural gas production that would require an assessment of damages which petitioners aver would be extremely difficult if not impossible to ascertain, since the total amount of natural gas recoverable by petitioners can only be determined through maintenance of the leases. Moreover, such loss of production would result in petitioners thereafter being unable to meet contracts for the sale of natural gas to United and other parties; and that payment at this time of the additional sums demanded would be unrecoverable in the eventuality that this Court adopts the interpretation of the phrases "market rate" and "market price" advocated by petitioners.

XXXV.

Accordingly petitioners aver that they fear immediate and irreparable harm, loss and damage and that they will be unlawfully deprived of their rights and that they are without any adequate remedy at law in the premises; and that it is necessary in order to protect petitioners' rights that this Honorable Court issue a temporary restraining order and thereafter an injunction prohibiting, restraining and enjoining defendants, their officers, agents, representatives, attorneys and employees, and all other persons acting in concert or participation therewith, from hindering the orderly prosecution of this suit, and from taking any action to alter or disturb the contractual status now existing among the parties pursuant to the 1934 and 1952 Williams Leases or either of them or to cancel, terminate or assert cancellation or termination of the 1934 and 1952 Williams Leases, or either of them.

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XXXVI.

Petitioners fear that during the pendency of this proceeding defendants, their officers, agents, representatives, attorneys, and employees, and other persons acting in concert or participation therewith, will attempt to cancel or terminate the 1934 and 1952 Williams Leases and divest this Honorable Court of jurisdiction to decide this controversy and so deprive petitioners of their rights in the premises.

XXXVII.

Due to the fact that defendants, their officers, agents, representatives, attorneys and employees and all other persons acting in concert or participation with them, may accomplish the purpose stated in said order to the immediate and irreparable harm, loss and damage of petitioners, it is necessary, in order to protect petitioners' rights, that a temporary restraining order issue herein before notice and hearing in the form and substance mentioned above upon petitioners' furnishing such bond as the Court may direct.

WHEREFORE, petitioners pray that defendants be served with a copy of this petition and that:

1. Upon petitioners furnishing a bond in an amount to be fixed by the Court, a temporary restraining order issue herein according to law directed to defendants and restraining, enjoining and prohibiting defendants, their agents, employees and all other persons, firms or corporations acting or claiming to act in their behalf, from hindering the orderly prosecution of this suit, and from taking any action to alter or disturb the contractual status now existing among the parties pursuant to the 1934 and 1952 Williams Leases or either of them or to cancel, terminate

or assert the cancellation or termination of the 1934 and 1952 Williams Leases, or either of them.

2. Defendants be duly ordered to show cause on a day and at a time to be fixed by this Court, why a preliminary injunction

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in the form and of the substance of the temporary restraining order prayed for above should not be issued herein and that after due proceedings be had, there be judgment herein making the said rule absolute and that a preliminary and permanent injunction be issued in the form and of the substance of the temporary restraining order prayed for herein.

3. An attorney be appointed to represent the defendants who are nonresidents of the State of Louisiana or absentees, and that this proceeding be conducted contradictorily against such attorney.

4. Defendants be duly cited to appear and answer this petition, and after legal delays and due proceedings had, there be judgment herein in favor of petitioners Shell and Pennzoil, and against defendants, perpetuating and making permanent the preliminary injunction prayed for above.

5. There be further judgment herein declaring that petitioners' interpretation of the phrases "market rate" and "market price" in the subject leases is correct, that petitioners have properly discharged their royalty obligations to defendants on the basis of the Federal Power Commission regulated rate in effect for the periods in question and may continue to so discharge such obligations while any regulated rate established by the Federal Power Commission remains in effect, and that the 1934 Williams Lease and the 1952 Williams Lease are still in force and effect, notwithstanding the demands made by defendants in the Williams Letter.

6. Alternatively, in the event that the Court should conclude that petitioners' interpretation of the phrases "market rate" and "market price" in the subject leases is incorrect and that as a result petitioners have not remitted to defendants royalties measured on a proper basis, that there be judgment herein declaring that petitioners are entitled to remit such

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payment, that the 1934 Williams Lease and the 1952 Williams Lease continue in force and effect, notwithstanding the demands made by the defendants in the Williams Letter.

7. Such further or supplemental relief be granted as may be necessary or proper.

8. The Court grant petitioners general and equitable relief and award petitioners all costs of this proceeding.

LEMLE, KELLEHER,
KOHLMEYER &
MATTHEWS

By: ....

Harry B. Kelleher,
Murphy Moss and
Ernest L. Edwards
1800 First National
Bank of Commerce
Building
New Orleans, Louisiana
70112
Telephone: 586-1241

SHELL OIL COMPANY:
Alvin B. Gibson

PENNZOIL PRODUCING
COMPANY:
G. Bruce Mallum
A. Duncan Gray, Jr.
Richard B. Wilkins

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EXHIBIT 5 (ADG-5)

CIVIL DISTRICT COURT
FOR THE
PARISH OF ORLEANS
STATE OF LOUISIANA

NO. 573-581 DIVISION "A" DOCKET 5

SHELL OIL COMPANY and
PENNZOIL PRODUCING COMPANY

vs.

WILLIAMS, INC., *et al.*

FILED: ....
Deputy Clerk

ANSWER AND RECONVENTIONAL DEMAND

Now into Court, through undersigned counsel, come Williams, Inc. and Frank B. Williams, individually and as Executor of the Succession of Mrs. Delphine C. Williams, Laurence M. Williams, The Kemper and Leila Williams Foundation, Lucille W. Mayfield Trusts for Ann Marsak and for Alec Andrew Johnson, Ann Marsak, Alec Andrew Johnson, Mrs. Katherine W. Tremaine, Elizabeth Williams Trust, Elizabeth Williams, Mrs. Elizabeth Campbell Brooks, Whitney L. Brooks, Trustee for Anne Campbell, Alan Adams Campbell, and Valley Bank & Trust Company, Executor u/w Holbrook Campbell, the defendants named herein ("respondents"), and for answer to the petition of plaintiffs, Shell Oil Company ("Shell") and Pennzoil Producing Company ("Pennzoil"), state:

1.

Respondents admit that Shell is the successor in interest of Shell Petroleum Corporation and that Shell is engaged in the production of oil and gas. All other allegations of Paragraph I are denied for lack of sufficient information and knowledge sufficient to justify belief.

2.

The respondents admit the allegations of Paragraph II.

3.

The respondents admit the allegations of Paragraph III.

4.

The respondents admit the allegations of Paragraph IV.

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5.

The respondents admit the allegations of Paragraph V.

6.

The allegations of Paragraph VI are admitted, except that the respondents affirmatively assert that the royalty payments which have been received are less than the amount required by the leases and less than the amounts which have been demanded by the respondents.

7.

The respondents deny that the 1934 Williams Lease has been continuously maintained in force and effect. The respondents further deny that the royalty payments have been made in conformity with the provisions of the lease; rather, respondents aver that the royalty payments made since October 1, 1971, and possibly prior thereto, were in violation of the lease and, as hereinafter set forth, created a basis for cancellation of the lease. The lease has been

cancelled by Williams, Inc. in accordance with its terms and is no longer in effect. Respondents further aver that releases of acreage from the lease subsequent to March 1, 1937 reduced the leased acreage to 1,864.71 acres. All other allegations of Paragraph VII are admitted.

8.

The respondents admit the allegations of Paragraph VIII.

9.

The respondents deny the allegations of Paragraph IX for lack of information sufficient to justify a belief, except that respondents admit that Shell had the obligation to develop the 1934 Williams Lease. Williams, Inc. affirmatively avers that it was not a party to any election made by Shell as to development of markets for gas or in arrangements or contracts for the transportation of gas produced from the leased properties. The terms of any contracts made by Shell with third persons, referred to in this paragraph, were reached without review or consent of the respondents with the consequent result that Shell bears the risk inherent to those contracts.

10.

The respondents admit the allegations of Paragraph X, except that the respondents affirmatively state that any approval was a mere accommodation to Shell as a lessee. The terms and conditions of that sublease, including

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the method of transportation of the gas and the method of marketing gas, were exclusively the decisions of Shell, and at Shell's risk.

11.

The respondents deny the allegations of Paragraph XI for lack of information sufficient to justify a belief.

12.

The respondents deny the allegations of Paragraph XII for lack of information sufficient to justify a belief.

13.

The respondents deny the allegations of Paragraph XIII for lack of information sufficient to justify a belief. Respondents affirmatively aver that Williams, Inc. and the other defendants are not parties to the contract described therein, that such contract was entered into without the approval or consent of Williams, Inc. or other respondents, and that the parties to that contract bear the risks of that contract.

14.

The respondents aver that Paragraph XIV states a conclusion of law and does not require an answer. Out of an abundance of caution, respondents deny the allegations of Paragraph XIV.

15.

The respondents admit the allegations of Paragraph XV.

16.

The respondents deny the allegations of Paragraph XVI for lack of information sufficient to justify a belief.

17.

The respondents deny the allegations of Paragraph XVII for lack of information sufficient to justify a belief.

18.

The respondents deny the allegations of Paragraph XVIII for lack of information sufficient to justify a belief. Respondents further aver that they were not parties to the contract described therein, did not approve or consent to

its terms, and that the contracting parties bear the risks of their agreement.

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19.

The respondents deny the allegations of the first two sentences of Paragraph XIX for lack of information sufficient to justify a belief. The remainder of Paragraph XIX states a conclusion of law and does not require an answer, but out of an abundance of caution, respondents deny all of the allegations of Paragraph XIX.

20.

The first and last sentences of Paragraph XX state legal conclusions that do not require an answer, but out of an abundance of caution, respondents deny these allegations. All remaining allegations of Paragraph XX are denied for lack of information sufficient to justify a belief. Further, respondents aver that the agreements methods and contractual arrangements by which Shell and Pennzoil choose to sell, market and transport the gas produced from the leases involves an election made by Shell and Pennzoil to which the respondents are not parties. The respondents further assert that the transfer of gas from the respondents to the plaintiffs is not a transfer or sale subject to the jurisdiction of the Federal Power Commission and that the payment of royalties by the plaintiffs to the respondents for the gas produced, and the determination of the amount of the royalties, does not involve the jurisdiction of the Federal Power Commission. *Mobil Oil Company* v. *Federal Power Commission,* 463 F.2d 256, *cert. denied,* 496 U.S. 976 (1972).

21.

The respondents deny the allegations of Paragraph XXI, for lack of information sufficient to justify a belief, except

that payments from time-to-time have increased. The respondents further deny any implication that the royalty payments are governed by the Federal Power Commission rates, and aver that the payments violate the terms of the leases.

22.

The respondents deny the allegations of Paragraph XXII for lack of information sufficient to justify a belief.

23.

The respondents admit the allegations of Paragraph XXIII.

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24.

The respondents admit the allegations of Paragraph XXIV, except that the respondents aver that the 60-day period has expired and the respondents have been informed by certified letter of June 5, 1974 that the leases are now cancelled.

25.

The respondents admit the allegations of the first two sentences of Paragraph XXV, and the schedule of prices per MCF, but deny all other allegations of Paragraph XXV.

26.

The respondents deny the allegations of the first sentence of Paragraph XXVI for lack of information sufficient to justify a belief. The defendants deny all other allegations of Paragraph XXVI.

27.

The respondents admit that Williams, Inc. accommodated its lessee Shell by consenting on behalf of itself and its royalty distributees to the sublease to Union and that the

then royalty distributees were aware of the approval. All other allegations of Paragraph XXVII are denied. The respondents further aver that the election to sell and transport the gas in the interstate market was the sole decision of the plaintiffs, with the consequence that the plaintiffs assumed the business risks incident to the gas sales contracts.

28.

The first two sentences of Paragraph XXVIII state legal conclusions that require no answer, but out of an abundance of caution, respondents deny such allegations. The respondents deny the allegations in the last sentence of Paragraph XXVIII for lack of information sufficient to justify a belief.

29.

The respondents deny the allegations of the first sentence of Paragraph XXIX for lack of information sufficient to justify a belief and deny the allegations of the last sentence of Paragraph XXIX.

30.

Paragraph XXX of plaintiff's petition does not contain allegations of facts, but merely states plaintiff's conclusion with respect to a hypothe-

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tical factual situation, and does not require an answer. Out of an abundance of caution, respondents deny the allegations of Paragraph XXX.

31.

The respondents deny the allegations in the first sentence of Paragraph XXXI for lack of information sufficient to justify a belief and deny the last sentence of Paragraph XXXI.

32.

The respondents deny the allegations of Paragraph XXXII.

33.

The respondents admit that the plaintiffs should remit to the respondents the difference between the amounts presently being paid and the "market price" and "market rate," should the Court conclude that plaintiff have incorrectly interpreted those phrases. The respondents deny that remission of these additional royalty funds in compliance with a final judgment of this Court should entitle the plaintiffs to maintain the leases in force and effect. The respondents aver that the plaintiffs are not entitled to have the leases maintained in full force and effect, that the plaintiffs have breached the leases, that the respondents have properly cancelled the leases, and that the respondents are entitled to a judgment of this Court that the leases are no longer in effect.

34.

The respondents deny the allegations of Paragraph XXXIV.

35.

The respondents deny the allegations of Paragraph XXXV.

36.

The respondents deny the allegations of Paragraph XXXVI, except that respondents admit that respondent Williams, Inc. has declared the leases cancelled in accordance with the terms of the leases, but that respondents have abided by the Temporary Restraining Order and Preliminary Injunction heretofore issued by this Court by not interfering with the production, management and possession of the Gibson Field.

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37.

The respondents deny the allegations of Paragraph XXXVII.

And now by way of defense, the respondents further affirmatively answer:

38.

The obligations owed by the plaintiffs to the respondents under the leases are governed solely by the leases which call for payment of gas royalties at "market price" or "market rate". The respondents are not being paid royalties at "market price" or market rate." The respondents are not bound by any contracts to which they are not parties and bear no risks of those agreements.

39.

The respondents aver that United Gas Pipe Line Company was, until April of 1974, a wholly-owned subsidiary of Pennzoil and therefore Pennzoil's agreement to sell gas produced from Gibson Field under the leases to United Gas Pipe Line Company does not represent an agreement or contract negotiated at arms length because of the corporate relationship of the parties. Respondents specifically deny that the agreement constitutes a transaction of any probative value in determining "market price" or "market rate".

40.

The Federal Power Commission has no jurisdiction or authority over the royalties paid to the respondents under the leases, nor has the Federal Power Commission ever set a rate for royalties to be paid under the leases. *Mobil Oil Corporation* v. *Federal Power Commission,* 463 F.2d 256, *cert. denied,* 496 U.S. 976 (1972).

41.

If payment of royalties at "market price" or "market rate", in compliance with the lease terms, increases the expenses to be borne by the plaintiffs, they have a readily available remedy in the form of formal agency procedures for seeking an adjustment in the area rate. *Placid Oil Company* v. *Federal Power Commission,* 483 F.2d 880-911 (5th Cir. 1973).

WHEREFORE, the defendants pray that the demand of the plaintiffs be rejected and that the plaintiffs be ordered to pay all costs of this suit.

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AND NOW, as reconvenor, assuming the position of plaintiff-in-reconvention, the respondents show to the Court:

42.

By Mineral Lease dated August 29, 1934, F. B. Williams Cypress Company, Ltd. and C. S. Williams, Trustee, as lessors, granted Shell Petroleum Corporation, as lessee, a lease covering 61,442 acres of lessor's land situated in the Parishes of Iberville, Assumption, Iberia, St. Martin and Terrebonne ("the 1934 Williams Lease") for a five year primary term to commence with a selection date set forth therein. In accordance with the 1934 Williams Lease and subsequent agreements between lessors and lessee, Shell selected 3,508.81 acres owned by F. B. Williams Cypress Company, Ltd. in Terrebonne Parish, known as Area "K", which forms a portion of the present oil and gas field known as the Gibson Field. Subsequent releases of acreage by the lessee has reduced the total Williams, Inc. acreage in Gibson Field held under lease to Shell until June 5, 1974, to 1,864.71 acres. Lands of lessor C. S. Williams, Trustee, included under the lease did not form part of Area "K" in

Terrebonne Parish and are therefore not involved in this action.

43.

An oil well designated as the Shell Pelican No. 2 was completed as a producer on the leased premises in Area "K", and the 1934 Williams Lease was maintained in effect beyond its primary term by production until recently, when the lease was cancelled by the lessor as hereinafter set forth.

44.

By instrument dated October 13, 1934, F. B. Williams Cypress Company, Ltd. and Williams, Inc., a Louisiana corporation, entered into a joint agreement of consolidation which resulted in the creation of a new corporation under the laws of the State of Louisiana, namely, Williams, Inc., which thereupon became vested with title to the 1934 Williams Lease. By Act of Sale executed on February 21, 1935 before Lawrence K. Benson, Notary Public, Williams, Inc. (the Louisiana corporation) sold to Williams, Inc., a Delaware corporation, one of the defendants herein, all of the lands owned by the Louisiana corporation, thus transferring the land in Terrebonne Parish effected by the 1934 Williams Lease to Williams, Inc., the Delaware corporation.

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48.

By sublease dated December 29, 1942, effective as of December 24, 1941, Shell subleased to Union Producing Company its rights in the gas and certain other liquid hydrocarbons produced and to be produced under the 1934 Williams Lease and other leases by different lessors in

the Gibson Field. Under the terms of the lease, the lessor must approve any assignment or sublease. As an accommodation to Shell, Williams, Inc., as lessor, formally approved the sublease to Union Producing Company.

49.

By Oil, Gas and Mineral Lease dated July 24, 1952, Williams, Inc., as lessor, leased to Mrs. Delphine C. Williams, Frank B. Williams, Elizabeth Williams Zorthian, Mrs. Leila Moore Williams, L. Kemper Williams, Mrs. Katharine Williams Tremaine, Laurence M. Williams and Mrs. Lucille Williams Mayfield, as lessees, a 20-acre tract situated in Section 36, T17S, R15E, Terrebonne Parish ("the 1952 Williams Lease"), which land is located within the Gibson Field. The named lessees assigned the 1952 Williams Lease to Shell Oil Company by assignment dated January 4, 1955. The lease was amended by Williams, Inc. and Shell by instrument dated January 24, 1955, which amendment increased the royalty stipulated under the lease from an undivided one-sixth interest to an undivided one-fourth interest.

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50.

On information sufficient to justify a belief, the respondents aver that Shell Oil Company ("Shell") is the successor to Shell Petroleum Corporation, the original lessee, and that Pennzoil Producing Company ("Pennzoil") is the successor to Union Producing Company, the sublessee of gas rights under the 1934 Williams Lease, and that Shell and Pennzoil are obligated to Williams, Inc., as lessee and partial royalty owner, and the other respondents, as royalty owners under the 1934 Williams Lease, to the same extent as their predecessors, Shell Petroleum Corporation and Union Producing Company, respectively.

51.

Paragraph 4 of the 1934 Williams Lease provides in part that:

> "Lessee agrees as to royalties: . . . to pay Lessor for gas and/or casinghead gas produced and saved by Lessee from the land hereby leased, (a) one-eighth (1/8) of the value thereof, calculated at the market rate prevailing at the well, for all such gas and/or casinghead gas used or sold for the manufacturer of gasoline, naptha, or any related product, for the operating of a sulphur plant, and (b) one-eighth (1/8) of the value thereof, calculated at the market rate prevailing at the well, for all such gas and/or casinghead gas used or sold off said land for purposes other than the manufacture of said products. . . ."

52.

Paragraph 3 of the 1952 Williams Lease, as amended, contains an identical royalty clause as quoted in the preceding paragraph except the percentage of royalty is "one-fourth" rather than "one-eighth."

53.

During the latter part of 1972 Williams, Inc. realized that gas royalties being paid to the respondents by Pennzoil and Shell were far below the actual market value of the gas, based on comparable gas sales in the area. By letters to Shell and Pennzoil, each dated February 7, 1973 (copies of which are attached hereto as Exhibits "A" and "B"), Williams, Inc. asserted the discrepancy in price and requested advice as to the intention of the parties to adjust royalty payments to reflect actual market value of gas. Responses from the plaintiffs indicated that the respondents were being paid royalties on the basis of a percentage of the proceeds received by the plaintiffs pursuant to sales of all gas produced to United Gas Pipe Line Co. (the

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wholly-owned subsidiary of Pennzoil), rather than on the basis of the market value of the gas, as provided in the leases.

54.

By certified letters to Shell and to Pennzoil Producing Company and Pennzoil Company dated June 7, 1973 (copies of which are attached hereto as Exhibits "C" and "D"), Williams, Inc. made demand upon the addressees to comply with the obligations of the lessee under the 1934 Williams Lease by paying on all past royalties the amount by which the market value of the gas produced exceeded the amount actually paid to the royalty owners.

55.

Thereafter, representatives of Williams, Inc. and the plaintiffs conferred with respect to the demands of Williams, Inc. During these negotiations, Williams, Inc. suspended the formal demand against the plaintiffs made in its letters of June 7, 1973.

56

Because of the plaintiffs' continued refusal to pay the respondents the market value of gas produced under the leases in accordance with the terms of the leases, Williams, Inc. on behalf of itself as lessor and royalty owner under both the 1934 Williams Lease and the 1952 Williams Lease, and on behalf of all of the royalty owners named in paragraph 47 above under the 1934 Williams Lease, made formal demand by certified letter dated March 27, 1974 addressed to Shell, Pennzoil Company and Pennzoil Producing Company, for compliance with the obligations under both leases to pay lessor and its assigns the gas royalty calculated on the basis of the market rate prevailing at the well. The certified letter also stated the amounts that

Williams, Inc. considered owing through December 31, 1973 because of the plaintiffs' failure to pay royalties in accordance with the leases and stated the basis for such calculation. The letter further demanded cancellation and termination of the leases in view of the failure of the lessee and its related parties to comply with the obligations under the leases with respect to payment of proper royalties. A copy of the certified letter of March 27, 1974 is attached hereto as Exhibit "E".

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57.

Despite the aforesaid demands, Shell and Pennzoil failed to remedy their default under the leases. By certified letter to Shell and Pennzoil dated June 5, 1974 (a copy of which is attached hereto as Exhibit "F"), Williams, Inc. declared the 1934 Williams Lease and the 1952 Williams Lease to be terminated because of the failure of Shell and Pennzoil to pay proper royalty in accordance with the terms of the leases.

58.

From October 1, 1971 through May 31, 1974 (the most recent accounting date prior to the date of termination), the plaintiffs underpaid royalties to respondents on gas produced from Gibson Field in the aggregate amount of $1,544,771.39, of which Pennzoil underpaid $1,055,204.62 and Shell underpaid $489,566.77. These amounts represent the difference between the royalties actually paid and the royalties that should have been paid by the plaintiffs based on the value of gas, calculated at the market price prevailing at the well in accordance with the terms of the leases, using the following market rates which respondents believe prevailed in the area during the period from October 1, 1971 through May 31, 1974:

Period	Price of Gas Per Thousand Cubic Feet (MCF)
October 1, 1971 — March 2, 1973	$ .35
March 3, 1973 — September 30, 1973	$ .45
October 1, 1973 — November 8, 1973	$ .54
November 9, 1973 — May 31, 1974	$ .70

59.

The plaintiffs' failure to pay royalties in accordance with the terms of the 1934 Williams Lease and the 1952 Williams Lease is sufficient grounds for cancellation and termination of the leases. The respondents have complied with all conditions imposed under the leases for cancelling the leases by giving the plaintiffs 60-day written notice of plaintiffs' default under the leases and stating the facts upon which respondents' demand was based.

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60.

Defendants' failure to comply with the plaintiffs' demand within the 60-day period following the date of demand entitled Williams, Inc. to cancel the leases, as it did in its letter to the plaintiffs dated June 5, 1974.

61.

By virtue of the cancellation of the leases by Williams, Inc., the leases are no longer in force and effect. Accordingly, Williams, Inc. as owner of the land is entitled to be paid the value of 100 percent of all oil, gas and other hydrocarbons and minerals extracted and removed from its lands previously covered by the 1934 Williams Lease and the 1952 Williams Lease, and the plaintiffs are obligated to account to Williams, Inc. for the value of the production since cancellation of the leases on June 5, 1974.

62.

In addition to the foregoing, the plaintiffs are liable unto Williams, Inc. for reasonable attorneys' fees incurred in bringing this suit to have the cancellation adjudged and for all damages suffered by Williams, Inc. by reason of its inability to contract in regard to the mineral rights because of the plaintiffs' failure to acknowledge the cancellation. La. R.S. 30:101-102.

63.

Respondents reserve their rights to amend this reconventional demand to allege additional amounts owed as royalties if further investigation reveals that the market rate of gas exceeds the rates alleged in paragraph 58 hereof.

WHEREFORE, respondents pray that there be judgment herein in favor of the respondents and plaintiffs-in-reconvention and against the plaintiffs and defendants-in-reconvention as follows:

1. With respect to plaintiffs' demand for declaratory judgment, declaring that plaintiffs' interpretation of the phrases "market rate" and "market price" in the leases is erroneous and that the respondents' interpretation of these phrases is correct, that the plaintiffs have failed to discharge their royalty obligations to the respondents in accordance

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with the subject leases and that the subject leases are no longer in force and effect.

With respect to respondents' reconventional demand:

2. Decreeing that the 1934 Williams Lease and the 1952 Williams Lease were cancelled and terminated as of June 5, 1974, and ordering the plaintiffs to relinquish possession of the leased premises to Williams, Inc.

3. Awarding Williams, Inc. reasonable attorneys' fees incurred in bringing this suit to have the cancellation of the leases adjudged in this proceeding.

4. Awarding Williams, Inc. damages suffered by it by reason of its inability to contract in regard to the mineral rights because of the failure of the plaintiffs to acknowledge the cancellation.

5. Ordering Pennzoil to pay the respondents damages in the amount of $1,055,204.62 and Shell to pay respondents damages in the amount of $489,566.77 for underpaid royalties through May 31, 1974, and ordering the plaintiffs to account to the defendants and pay in damages the difference between the market value of royalty gas collected and sold by the plaintiffs from June 1 through June 5, 1974, such award of damages to be divided among the respondents in accordance with their percentage ownership of royalties set forth in paragraph 48 of respondents' reconventional demand.

6. Ordering the plaintiffs to account to Williams, Inc. for the value of all oil, gas and other hydrocarbons and minerals extracted after June 5, 1974 from the lands heretofore leased to the plaintiffs under the leases, and after the accounting is made, ordering the plaintiffs to pay such amounts to Williams, Inc. as damages.

7. Ordering the plaintiffs to pay legal interest on the amounts due to the respondents from the date of judicial demand until paid, and to pay all costs of this proceeding.

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8. Granting respondents all general and equitable relief to which they may be entitled.

. . . .

Campbell C. Hutchinson

. . . .

Anthony M. DiLeo
Of
STONE, PIGMAN, WALTHER, WITTMANN & HUTCHINSON
1000 Whitney Bank Building
New Orleans, Louisiana 70130
Telephone: 581-3200

Attorneys for Respondents and Plaintiffs-In-Reconvention

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EXHIBIT 6 (ADG-6)
CIVIL DISTRICT COURT
FOR THE
PARISH OF ORLEANS
STATE OF LOUISIANA

NO. 573-581 DIVISION "A" DOCKET 5

SHELL OIL COMPANY
AND
PENNZOIL PRODUCING COMPANY
VS.
WILLIAMS, INC., *et al*

FILED: June 27, 1975

Deputy Clerk

SUPPLEMENTAL AND AMENDING RECONVENTIONAL DEMAND

Now into Court, through undersigned counsel, come Williams, Inc. and Frank B. Williams individually and as Executor of the Succession of Mrs. Delphine C. Williams, Laurence M. Williams, The Kemper and Leila Williams Foundation, Lucille W. Mayfield Trusts for Ann Marsak and for Alec Andrew Johnson, Ann Marsak, Alec Andrew Johnson, Mrs. Katherine W. Tremaine, Elizabeth Williams, Trust, Elizabeth Williams, Mrs. Elizabeth Campbell Brooks, Whitney L. Brooks, Trustee for Anne Campbell, Alan Adams Campbell, and Valley Bank & Trust Company, Executor u/w Holbrook Campbell, defendants and plaintiffs-in-reconvention ("respondents") in the above-numbered and entitled proceeding, who supplement and amend their original reconventional demand filed herein on

July 17, 1974, with the written consent of counsel for the plaintiffs, in the following respects:

I. By adding an additional paragraph following paragraph 58 of the Reconventional Demand as follows:

58(a).

From June 1, 1974 through April 30, 1975 (the most recent month for which royalties have been paid), the plaintiffs underpaid royalties to respondents on gas produced from Gibson Field in the aggregate amount of $2,186,912.40, of which Pennzoil underpaid $1,989,-222.91 and Shell underpaid $197,689.49. These amounts represent the difference between the royalties actually paid and the royalties that should have been paid by the plaintiffs based on the value of gas, calculated at the market price prevailing at the well in accordance with the terms of the leases, using

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the following market rates which respondents believe prevailed in the area during the period from June 1, 1974 through April 30, 1975:

Period	Price of Gas Per Mcf
June 1, 1974-December 31, 1974	$1.30
January 1, 1975-April 30, 1975	$1.40

II. By adding an additional paragraph to respondents' original prayer following paragraph 6 of the prayer to read as follows:

6(a) In the alternative, if this Court holds that the 1934 Williams lease and the 1952 Williams lease were not cancelled and terminated as of June 5, 1974, ordering Pennzoil to pay respondents damages in the amount of $3,044,427.53 and Shell to pay respondents damages in the amount of $597,256.26 for underpaid royalties through April 30, 1975, and additional damages equal to the excess of the market value of royalty gas over the amounts actually paid to the respondents as gas royalties for the period from May 1, 1975 to the date of judgment, such award to be divided among the respondents in accordance with their percentage ownership of royalties set forth in paragraph 48 of respondents' reconventional demand.

WHEREFORE, respondents, reiterating the prayer of their original Reconventional Demand, as supplemented and amended herein, pray that this supplemental and amending reconventional demand be filed, and that after due proceedings, there be judgment herein in favor of the respondents, in accordance with the original prayer, as supplemented and amended herein.

Campbell C. Hutchinson
Of
Stone, Pigman, Walther, Wittmann & Hutchinson
1000 Whitney Bank Building
New Orleans, Louisiana 70130
Telephone: 581-3200
Attorneys for Respondents and Plaintiffs-in-Reconvention

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June 18, 1975

United Gas Pipe Line Company
P. O. Box
Houston, Texas 77001

Gentlemen:

Please refer to that certain gas purchase contract effective November 1, 1959, as heretofore amended ("Contract"), by and between United Gas Pipe Line Company, as Buyer, and Union Producing Company (predecessor to Pennzoil Producing Company), as Seller, under the terms of which Buyer is purchasing from Seller merchantable natural gas produced from certain lands and leaseholds located in Gibson Field, Terrebonne Parish, Louisiana. Seller has advised, as a result of litigation pending in *Shell Oil Company and Pennzoil Producing Company* v. *Williams, Inc., et al.,* Docket No. 573-591 (Civil District Court for the Parish of Orleans, State of Louisiana), that Seller may be required to make royalty payments to its lessors at a rate in excess of the rate heretofore paid as royalty or that in the absence of such greater royalty payments certain lessors have threatened to terminate some of the underlying leases. Seller has also advised that it is likely that other royalty owners in the Gibson Field will make similar demands. Seller has also advised that pursuant to a Settlement Agreement between Seller and certain of Seller's lessors, a copy of which is attached hereto as Exhibit A, payment of increased royalties or release of one-eighth of the gas back to such lessors may be required or permitted by the Federal Power Commission. In order to avoid the termination of leases, and loss of gas to Seller and Buyer, Seller has requested that Buyer reimburse Seller for such excess payment for each of its lessors in the Gibson Field or, in the alternative, release the royalty portion of the gas from the

terms of the Contract. Buyer is agreeable to such arrangement on the following terms; accordingly, the parties hereto do hereby agree as follows:

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1.

In the event Seller receives authorization from the Federal Power Commission to collect from Buyer increased sums payable to Seller's lessors as royalty on gas delivered after January 1, 1974, under the Contract, Buyer shall, beginning on the date Seller is authorized to collect such amounts, pay to Seller such sums covering the periods authorized by the Federal Power Commission. Any payments authorized by the Federal Power Commission for royalty gas delivered after January 1, 1974 through the date of the FPC's final order shall be amortized over a period of one year from the date of the FPC's final order. In the event of the cessation of Federal Power Commission regulation of producer gas sales as described in Exhibit A hereto, Buyer shall at all times pay to Seller the sums necessary to permit Seller to pay each of its lessors in the Gibson Field who have the right to receive a royalty on gas sold from such field by Seller to Buyer (regardless of whether such lessor is a party to the attached Exhibit A) the royalties specified in Exhibit A hereto; such payments shall be made from time to time as necessary to permit Seller to remit such sums to its lessors in a timely fashion and without regard to any other provision of the November 1, 1959 Contract, except as amended hereby.

This Section 1 of this amendatory agreement shall automatically become void and of no force or effect on the date the Settlement Agreement attached hereto as Exhibit A is terminated pursuant to the terms thereof.

2.

In the event Seller receives authorization from the Federal Power Commission to abandon or release to its lessors one-eighth ($1/8$) of such gas, Buyer will amend the Contract in such manner as to effect the release of such one-eighth ($1/8$) of such gas from the terms and provisions of the Contract; provided that Buyer will have no obligation under Sections 1 and 2 hereof unless and until either of the alternative authorizations is granted by final order of the Federal Power Commission as contemplated hereby.

3.

By its execution hereof Buyer does not become a party to, an obligor or guarantor under, beneficiary of or bound in any way by the Settlement Agreement attached hereto as Exhibit A.

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4.

This agreement shall become effective as of the date first hereinabove written.

5.

This agreement is subject to all present and future orders, rules and regulations of any governmental or regulatory body having jurisdiction.

If the foregoing is in accordance with your understanding of the agreement between us, please so signify by executing the duplicate originals hereof in the space provided below and returning one of such originals to us. On our execution hereof, this agreement shall constitute an amendment to the

Contract and shall be binding upon us and upon our respective successors and assigns.

Very truly yours,

PENNZOIL PRODUCING COMPANY

By James T. Goodwyn

ACCEPTED AND AGREED TO:

UNITED GAS PIPELINE COMPANY

By D. Lamar Smith

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June 23, 1975

United Gas Pipe Line Company
P. O. Box 1478
Houston, Texas 77001

Gentlemen:

Please refer to that certain gas purchase contract effective May 1, 1959, as heretofore amended ("Contract") by and between United Gas Pipe Line Company, as buyer, and Shell Oil Company, as Seller, under the terms of which Buyer is purchasing from Seller merchantable natural gas produced from certain lands and leaseholds located in Gibson Field, Terrebonne Parish, Louisiana. Seller has advised, as a result of litigation pending in *Shell Oil Company and Pennzoil Producing Company* v. *Williams, Inc., et al.*, Docket No. 573-591 (Civil District Court for the Parish of Orleans, State of Louisiana), that Seller may be required to make royalty payments to its lessors at a rate in excess of the rate heretofore paid as royalty or that in the absence of such greater royalty payments certain lessors have threatened to terminate some of the underlying leases. Seller has also advised that it is likely that other royalty owners in the Gibson Field will make similar demands. Seller has also advised that pursuant to a Settlement Agreement between Seller and certain of Seller's lessors, a copy of which is attached hereto as Exhibit A, payment of increased royalties or release of one-eighth of the gas back to such lessors may be required or permitted by the Federal Power Commission. In order to avoid the termination of leases and loss of gas to Seller and Buyer, Seller has requested that Buyer reimburse Seller for such excess payment for each of its lessors in the Gibson Field or, in the alternative, release the royalty portion of the gas from the terms of the Contract. Buyer is agreeable to such arrangement on the following terms; accordingly, the parties hereto do hereby agree as follows:

1.

In the event Seller receives authorization from the Federal Power Commission to collect from Buyer increased sums payable to Sellor's lessors as royalty on gas delivered after January 1, 1974, under the Contract, Buyer shall, beginning on the date Seller is authorized to collect such amounts, pay to

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Seller such sums covering the periods authorized by the Federal Power Commission. Any payments authorized by the Federal Power Commission for royalty gas delivered after January 1, 1974, through the date of the Federal Power Commission's final order, shall be amortized over a period of one year from the date of the Federal Power Commission's final order. In the event of the cessation of Federal Power Commission regulation of producer gas sales as described in Exhibit A hereto, Buyer shall at all times pay to Seller the sums necessary to permit Seller to pay each of its lessors in the Gibson Field who have the right to receive a royalty on gas sold from such field by Seller to Buyer (regardless of whether such lessor is a party to the attached Exhibit A) the royalties specified in Exhibit A hereto; such payments shall be made from time to time as necessary to permit Seller to remit such sums to its lessors in a timely fashion and without regard to any other provision of the (May 1, 1959) Contract, except as amended hereby.

This Section 1 of this amendatory agreement shall automatically become void and of no force or effect on the date the Settlement Agreement attached hereto as Exhibit A is terminated pursuant to the terms thereof.

2.

In the event Seller receives authorization from the Fed-

eral Power Commission to abandon or release to its lessors one-eighth (1/8) of such gas, Buyer will amend the Contract in such manner as to effect the release of such one-eighth (1/8) of such gas from the terms and provisions of the Contract; provided that Buyer will have no obligation under Sections 1 and 2 hereof unless and until either of the alternative authorizations is granted by final order of the Federal Power Commission as contemplated hereby.

3.

By its execution hereof Buyer does not become a party to, an obligor or guarantor under, beneficiary of or bound in any way by the Settlement Agreement attached hereto as Exhibit A.

4.

This agreement shall become effective as of the date first hereinabove written.

5.

This agreement is subject to all present and future orders, rules and regulations of any governmental or regulatory body having jurisdiction.

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If the foregoing is in accordance with your understanding of the agreement between us, please so signify by executing the duplicate originals hereof in the space provided below and returning one of such originals to us. On our execution hereof, this agreement shall constitute an amend-

ment to the Contract and shall be binding upon us and upon our respective successors and assigns.

Very truly yours,

SHELL OIL COMPANY

By S. M. Paine
General Manager
Production

ACCEPTED AND
AGREED TO:

UNITED GAS PIPELINE
COMPANY

By D. Lamar Smith

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MINERAL LEASE

KNOW ALL MEN BY THESE PRESENTS:

1. That *F. B. WILLIAMS CYPRESS COMPANY, LIMITED,* herein appearing and represented by its Vice-President, *C. S. WILLIAMS,* duly authorized, and *C. S. WILLIAMS,* Trustee, herein called *LESSOR* (whether one or more), for and in consideration of TEN THOUSAND AND NO/100 ($10,000.00) DOLLARS, the receipt of which, as a full and adequate consideration for every right granted herein, is hereby acknowledged, does hereby grant, demise and lease unto *SHELL PETROLEUM CORPORATION,* herein called *LESSEE,* for the purpose, and with the exclusive right, of exploring, prospecting, drilling, mining and operating for, and of producing and taking, oil, gas, casinghead gas, sulphur and all other minerals thereon and therefrom; of saving, storing, taking care of, treating, manufacturing, loading and transporting such substance thereon and therefrom; and of constructing, maintaining, using, enjoying and, at any time during or after the term hereof, removing any machinery, plants, stations, casing, pipes, pipe lines, tanks, bins, reservoirs, storage accommodations, camps, houses, or buildings, any telephone, telegraph, light or power cables or lines, any rail or other roads or ways, and, in general, any appliances, structures, equipment, easement, servitudes, and privileges which may be necessary, useful or convenient to or in connection with any such operations conducted by Lessee thereon, or on any adjacent lands, all that certain land lying in the Parishes of Iberville, Assumption, Iberia, St. Martin and Terrebonne, the said lands being more specificially described on a certain exhibit hereto attached, which has been initiated by the parties and marked Exhibit "A".

It is understood that C. S. WILLIAMS, Trustee, holds title to the following lands:

> "That certain tract of land situated in the Parish of Assumption, State of Louisiana, described as the Northeast Quarter and Lot 4 of Section 13, T. 14 S., R. 13 East, and Section 39 and the Northwest Quarter of Section 38, T. 14 S. R. 14 East, containing approximately 1030 acres, including such rights as the vender may have in a certain drainage canal forming part of the drainage
>
> [195]
>
> system of Drainage District No. 1 of Assumption Parish, generally referred to as the CAHCIRENE CANAL, together with all rights, ways, privileges, appurtenances, prescriptions and possessory rights, all batture and batture rights, and all other rights of a riparious nature, and all buildings and improvements on said property."

But for the purposes of this lease, all of the lands herein described shall be treated as a whole and as one unit as though held under one ownership.

2. For the purposes of determining the amount of money payment hereunder, said leased lands shall be considered to comprise sixty-one thousand four hundred forty-two (61,442) acres even though they actually comprise more or less, but it is Lessor's intention to lease and Lessor does hereby lease, in addition to the Land above described, all of the land now owned or claimed by Lessor by limitation or otherwise and located in said Parish EXCEPT those lands situated in the Parishes of Iberia and St. Martin, State of Louisiana, described as follows:

> East Half (E½) of Section 33; West Half (W½) of Section 34, West Half (W½) of Southeast Quarter (SE¼) of Section 34; Township 12 South, Range 11 East;

East Half (E½) of Section 4; West Half (W½) and Southwest Quarter (SW¼) of Northeast Quarter (NE ¼) and the Southwest Quarter (SW¼) of the Southeast Quarter (SE¼) of Section 3;

Township 13 South, Range 11 East, comprising 1440 acres.

Lessor expressly agrees to deliver to Lessee any supplemental instrument deemed necessary or required by Lessee for a more complete and accurate description of the lands thus intended to be leased.

3. This lease shall remain in force as to all minerals, and for all purposes covered thereby, for a primary term extending from the date hereof to, and to include five (5) years from and after the selection date fixed by Section 5 hereof, and as long after such primary term as, either (1) oil, gas, casinghead gas, sulphur, or any other mineral is produced by Lessee from the land hereby leased; or, (2) drilling or mining operations upon said land are being prosecuted by Leasee with reasonable diligence, and, in the absence of production, not more than ninety (90) days shall elapse between the completion or abandonment of one well or mine and the commencement of operations for the drilling or excavating of another.

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4. Lessee agrees as to royalties: First, to deliver to the credit of Lessor, free of expense in the pipe line to which Lessee may connect Lessee's wells the equal one-eighth (⅛) part of all oil produced and saved by Lessee from the land hereby Leased, or, from time to time, to pay Lessor the posted market price of such one-eighth (⅛) part of such oil as of the day it is run to the pipe line or storage tanks, Lessor's interest, in either case, to bear its proportion of any expenses of treating unmerchantable oil to render it merchantable as crude; provided that from time to time,

upon demand from Lessor so to do, Lessee shall be obligated to take said royalty oil and pay Lessor therefor the posted market price as above provided; Second, to pay Lessor for gas and/or casinghead gas produced and saved by Lessee from the land hereby leased, (a) one-eighth (⅛) of the value thereof, calculated at the market price prevailing at the well, for all such gas and/or casinghead gas used or sold for the manufacture of gasoline, naptha, or any related product, or for the operating of a sulphur plant, and (b) one-eighth (⅛) of the value thereof, calculated at the market rate prevailing at the well, for all such gas and/or casinghead gas used or sold off said land for purposes other than the manufacture of said products; Third, to pay Lessor One ($1.00) Dollar per long ton (2240 pounds) for all sulphur produced from the land hereby leased; Fourth, to pay Lessor what, under all the circumstances, shall be a reasonable money royalty for any other mineral produced and marketed by Lessee from said land.

* * * *

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September 26, 1975

The Honorable Samuel Z. Gordon
Administrative Law Judge
Federal Power Commission
825 North Capitol Street N.E.
Washington, D. C. 20426

In re: Pennzoil Producing Company
Docket No. RI76-8
Shell Oil Company
Docket No. RI76-10

Dear Sir:

At transcript page 83 and following, your Honor agreed to permit Shell to ask Mr. John F. Bruskotter certain questions dealing with revenues, volumes, taxes, and royalty costs, and permit him to supply this information for the record by mail. I am therefore enclosing the additional testimony of Mr. Bruskotter supplying this data. A copy of this data is also being supplied to Staff Counsel by courier. Copies have been mailed to the other parties to the proceedings.

Respectfully submitted,

THOMAS G. JOHNSON
Thomas G. Johnson

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ADDITIONAL PREPARED TESTIMONY OF JOHN F. BRUSKOTTER IN SHELL OIL COMPANY DOCKET NO. RI76-10

Q. At transcript page 83 and following, I asked you for a breakdown of the revenue received by Shell for the 1934 lease and the 1952 lease by lease, by price, and by volume. Would you give that to us now, please?

A. There are four prices being received by Shell from these leases, instead of the two prices stated in my earlier testimony. These prices and the volumes for the period from April 1, 1974 to April 1, 1975 are as follows:

1934 lease:

Price (¢ per Mcf)	Volume (MMcf)
30.1125	583.3
31.1125	245.4
58.8595	139.1
59.8855	62.6
	1030.4 Total

1952 lease:

Price (¢ per Mcf)	Volume (MMcf)
30.1125	135.2
31.1125	45.5
58.8595	67.4
59.8855	30.9
	279.0 Total

Q. On what pressure base are these prices calculated?

A. 15.025 psia.

Q. Why have you utilized the period April 1, 1974 to April 1, 1975?

A. I suggested the July 1975 figure as a benchmark because it was the most recent figure available. Upon further

study, it became apparent that on a monthly basis the variation in volumes would cause the unit price figure to be erratic. Therefore, I believe the annual figure is more representative of the volume price relationship. We used the period of April 1, 1974 to April 1, 1975 to be consistent with the time period used by Mr. Gray in his testimony.

Q. At transcript page 84, I asked you for the average price per Mcf of gas delivered or attributed to the 1934 lease for the month of July 1975. Would you now answer that question?

A. The average price attributed to Shell's interest in the 1934 lease for the period from April 1, 1974 to April 1, 1975 was 39.0¢ per Mcf.

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Q. What would the average price per Mcf be for the 1952 lease for the period from April 1, 1974 to April 1, 1975?

A. The average price per Mcf for the 1952 lease for this period was 41.6¢ per Mcf.

Q. At page 84, I asked you for the price per Mcf for each of the two leases if the additional royalty provided for in the settlement, based on a 78¢ per Mcf price, were permitted to be "flowed through" by the Commission?

A. For the 1934 lease, the price per Mcf would be 42.6¢ Mcf, and for the 1952 lease the price would be 50.6¢ Mcf.

Q. At page 88, I asked you to calculate the revenue remaining to Shell on each lease after deducting the additional royalty claimed by Williams Inc., the severance taxes due the State of Louisiana, and the operating costs testified to by you of 4.5¢. Would you do that now, please?

A. For the 1934 lease, the average revenue was 39.0. The royalty on this lease, based on the $1.40 per Mcf market

value claimed by Williams, would be 17.5¢. The Louisiana severance tax paid by Shell is 6.125¢. The operating cost was 4.5¢. Therefore, the net revenue to Shell on the 1934 lease would be 10.875¢ per Mcf. This would not include amortization of capital invested, return on investment, or federal income taxes.

Q. What is the revenue remaining to Shell on the 1952 lease, based on the same assumptions?

A. The revenue to Shell on the 1952 lease was 41.6¢ per Mcf. The royalty on this lease, based on the $1.40 per Mcf market value claimed by Williams, would be 35¢. The Louisiana severance tax paid by Shell would be 5.25¢. The operating costs of 4.5¢ are deducted. Therefore, the net loss to Shell on the 1952 lease would be 3.15¢ per Mcf.

Q. At page 90, the Staff requested that you supply a copy of the 1952 lease, identified as Exhibit No. 10 and received into evidence at page 91. Do you have that lease?

A. Yes. It is attached to this testimony.

Q. At transcript pages 103 and following, Staff counsel asked for a further breakdown of the 4.5¢ operating costs attributable to these leases. Are you able to provide such a breakdown?

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A. The major categories are: (1) direct lease expense; (2) overhead charges; (3) property taxes and insurance; (4) reconditioning and recompletion. The breakdown into these categories is as follows:

1. Direct lease expense —	3.8¢	per Mcf
2. Overhead charges —	0.5¢	"
3. Property taxes and insurance —	0.2¢	"

The reconditioning and recompletion costs are included in direct lease expense.

Q. At transcript page 105, the Staff asked for a further breakdown of direct lease expense. Have you been able to do this?

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A. Yes. I have broken this expense down into the following categories:

Surface Expenses	
Wellhead and Flowlines	.34
Testing and Treating	.63
Compression of Gas	.44
Gas Dehy. & Dist.	.22
Waste Water Handling	.15
Office Quarters and Field Equipment	.35
Field Supervision	.27
Other	.06
Subsurface Expenses	
Major Well Work	1.04
Routine Well Work	0.30
Total	3.80

Q. Have you been able to qualify any other cost items besides operating costs within the time allowed?

A. As I previously testified, the costing units involved include not only the two base leases, but also the attributable portion of 10 separate operating units within which these leases are included. These leases and units have been developed over a time period of 38 years. There are multiple reservoirs in the field, which gives the calculation a three dimensional character. Therefore, it is not possible, even by October 3, to develop the capital investment, amortization, return, and federal income taxes attributable to these leases.

Q. Do you have any suggestion as to how these costs could be estimated?

A. In the optional procedure cases the Commission made the assumption that the nationwide costs determined in the last Commission opinion were to be used in the absence of better figures. Therefore, I have reproduced the cost summary attached as Appendix C to Opinion 699H, substituting the 4.5¢ operating cost and the increased royalty which Shell would have to pay for the corresponding figures in the Commission cost analysis. This schedule is attached hereto as Appendix A. Using the 1972 average costs, the total cost for the 1934 lease is 59.07¢ Mcf. Using the trended cost, the total cost for the 1934 lease is 62.13¢ Mcf. For the 1952 lease, the cost using 1972 average figures is 76.57¢ per Mcf. Using the trended cost method for the 1952 lease, the total cost is 79.63¢ Mcf.

Q. Does Shell plan to present any additional cost data in this proceeding?

A. For the reasons above stated, we do not.

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APPENDIX A

COST COMPONENT	1972 DATA	TRENDED DATA	1972 DATA 1934 LEASE	TRENDED DATA 1934 LEASE	1972 DATA 1952 LEASE	TRENDED DATA 1952 LEASE
Successful Wells	5.68	6.15	5.68	6.15	5.68	6.15
Recompletions & Deeper Drilling	0.20	0.20	0.20	0.20	0.20	0.20
Lease Acquisition	3.83	4.28	3.83	4.28	3.83	4.28
Other Production Facilities	1.28	1.39	1.28	1.39	1.28	1.39
Subtotal	10.99	12.02	10.99	12.02	10.99	12.02
Dry Holes	3.77	3.72	3.77	3.72	3.77	3.72
Other Exploration	2.62	2.80	2.62	2.80	2.62	2.80
Exploration Overhead	0.82	0.82	0.82	0.82	0.82	0.82
Subtotal	7.21	7.34	7.21	7.34	7.21	7.34
Operating Expense	3.10	3.10	4.50	4.50	4.50	4.50
Regulatory Expense	0.20	0.20	0.20	0.20	0.20	0.20
Net Liquid Credit	(3.89)	(3.89)	(3.89)	(3.89)	(3.89)	(3.89)
Return on Working Capital	1.14	1.25	1.14	1.25	1.14	1.25
Return on Investment	21.42	23.21	21.42	23.21	21.42	23.21
Subtotal	40.17	43.23	*41.57	44.63	41.57	44.63
Royalty	7.65	8.23	17.50	17.50	35.00	35.00
Total	47.82	51.46	59.07	62.13	76.57	79.63

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OIL, GAS AND MINERAL LEASE

THIS AGREEMENT made this 24th day of July 1952, between WILLIAMS, INC., a Delaware corporation, authorized to do business in Louisiana, having its offices in the Whitney Building, New Orleans, Louisiana (hereinafter called "Lessor"), and MRS. DELPHINE C. WILLIAMS, a resident of New Orleans, Louisiana, FRANK B. WILLIAMS, a resident of New Orleans, Louisiana, MRS. ELIZABETH WILLIAMS ZORTHIAN, a resident of Altadena, California, MRS. LEILA MOORE WILLIAMS, a resident of New Orleans, Louisiana, L. KEMPER WILLIAMS, a resident of New Orleans, Louisiana, MRS. KATHARINE WILLIAMS TREMAINE, a resident of Santa Barbara, California, LAURENCE M. WILLIAMS, a resident of New Orleans, Louisiana, and MRS. LUCILLE WILLIAMS MAYFIELD, a resident of Tyler, Texas, (hereinafter collectively called "Lessee").

WITNESSETH:

1. Lessor in consideration of FOUR THOUSAND and 00/100 ($4,000.00) DOLLARS in hand paid, of the rentals and royalties herein provided, and of the agreements of Lessee herein contained, hereby grants, leases and lets exclusively unto Lessee for the purpose of testing by any method or methods for formation or structures, investigating, exploring, prospecting, drilling and mining for and producing oil, gas and all other minerals thereon and therefrom, and, but not exclusively, building roads or ways, canals, (as to which roads or ways and canals, Lessor, its successors, assigns and licensees shall, subject to Lessee's prior rights under this lease, have the right to use at its own risk), laying pipe lines, building tanks, power stations, telephone lines and other structures thereon to produce, save, take care of, treat, transport and own

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said products, and housing its employees, and at any time during, or within one hundred twenty (120) days after the expiration hereof, removing the same therefrom, the following described lands in Terrebonne Parish, Louisiana, to-wit:

> Twenty acres more or less out of Section 36, Township 17 South, Range 15 East, more particularly described as follows:
>
> Beginning at a point in the northerly boundary of said Section 36, at the most westerly corner of Section 17, said Township and Range; thence with the common line between said Sections 17 and 36 South 56° 53″ East 924′ to the most southerly corner of said Section 17, being a point at the northwesterly line of Section 16, said Township and Range; thence South 33° 7″ West at 315.4′ passing the most westerly corner of Section 16, 942.9′ to a corner; thence North 56° 53″ West 924′ to a corner; thence North 33° 7″ East at 878.3′ passing the most southerly corner of Section 18, 942.9′ to the point of beginning, containing twenty acres more or less.

For the purpose of calculating the payments hereinafter provided for, said land shall be treated as comprising 20 acres, whether it actually comprises more or less.

2. Subject to the other provisions herein contained, this lease shall remain in force as to all minerals and for all purposes covered hereby for a term (hereinafter called Primary Term) of five (5) years after the date hereof, and as long after such primary term as either (1) oil, gas, casinghead gas, condensate, sulphur or any other mineral is being produced in paying quantities by Lessee from the land hereby leased, or (2) drilling or mining operations upon said land are being prosecuted by Lessee with reasonable diligence, as hereinafter defined. Whenever in this lease there is a requirement of reasonable or due diligence,

without limiting otherwise the meaning of such requirement, such a provision shall be construed to require that (a) within ninety (90) days of the completion or discontinuance of work upon one well or mine, Lessee shall commence reworking operations or operations for the

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drilling or excavation of another well or mine; (b) the reworking, drilling or excavation shall be pursued with reasonable diligence in a bona fide effort to produce oil, gas or other mineral in paying quantities. Whenever in this lease there is a requirement that operations for the drilling of a well shall be begun, such operations shall be deemed to have begun when location has been staked and road, canal or other means of access to the location has been started and such operations, when begun, shall be pursued to commence actual drilling with reasonable diligence.

3. Lessee agrees as to royalties:

First, to deliver to the credit of Lessor, free of expense in the pipe line to which Lessee may connect Lessee's wells, or at the wells into tanks or storage facilities furnished by Lessor, the equal one-sixth (1/6) part of all oil produced and saved by Lessee from the land hereby leased, or, from time to time, at Lessor's election, to pay Lessor the posted market price of such one-sixth (1/6) part of such oil as of the day it is run to the pipe line or Lessee's storage tanks, Lessor's interest in either case, to bear its proportion of any expense of treating unmerchantable oil to render it merchantable as crude; provided that until and unless Lessee is given one hundred twenty (120) days notice by Lessor that Lessor elects to take royalty oil in kind, Lessee shall be obligated to take said royalty oil with Lessee's oil and pay Lessor therefor the posted market price as above provided; should Lessor elect to receive royalty oil in kind, Lessor shall furnish and pay for facilities on the leased

premises to receive and store said oil or means of transporting the same from the leased premises as currently produced. Lessor may, from time to time, exercise its rights of election to take royalty oil in kind or to require Lessee to purchase

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Lessor's royalty oil, all as above provided, by giving one hundred twenty (120) days notice to Lessee, and, without modification of the foregoing, Lessor may cancel or countermand any notice of election theretofore given at any time within ninety (90) days after giving the same. Lessee agrees that it will run said royalty oil into its receiving or measuring tank or tanks placed on said leased premises, and at regular intervals when Lessee runs its oil from said receiving or measuring tank or tanks into storage tanks or pipe line or other mode of transportation, Lessor agrees that Lessor's royalty oil at said time may be removed from said receiving or measuring tank or tanks. Should Lessor fail to have available storage or transportation facilities for its royalty oil when such oil is run from such receiving or measuring tank or tanks by Lessee, Lessee shall run and sell said royalty oil together with Lessee's portion of said oil unto Lessee's purchaser (or if the same is not being purchased, then to Lessor's credit in pipe line to which such oil may be run) notwithstanding any notice that Lessor may have given to Lessee that Lessor would take said royalty oil in kind; it being agreed that said election shall not become operative unless and until Lessor does furnish adequate receiving and storage or transportation facilities therefor;

Second, to pay Lessor for gas, condensate and/or casinghead gas produced and saved by Lessee from the land hereby leased, (a) one-sixth (1/6) of the value thereof, calculated at the market price prevailing at the well, for

all such gas, condensate and/or casinghead gas used in or sold for the manufacture of gasoline, naphtha or any related product, or for the operating of a sulphur plant, and (b) one-sixth (1/6) of the value thereof, calculated at the market price prevailing at the well, for all such gas, condensate and/or casinghead gas used or sold off said land for purposes other than the manu

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facture of said product; and

Third, to pay Lessor Two and 50/100 ($2.50) Dollars per long ton (2240 pounds) for all surplur mined and marketed from the land hereby leased; and

Fourth, to pay Lessor one-sixth (1/6) of the value, calculated at the market value prevailing at the well or mine, of all other minerals mined and marketed by Lessee from said land.

4. This lease shall terminate one (1) year after the date hereof, unless Lessee, on or prior to that date (hereinafter called "rental date"), either (a) begins operations for the drilling of a well on the property then covered hereby, or (b) pays or tenders to Lessor, or to the depository named in Paragraph 8 hereof, for account of Lessor, the sum of Two Thousand and 00/100 ($2,000.00) Dollars (hereinafter called "rental"). Such payment by Lessee shall cover the privilege of deferring the commencement of operations for the drilling of a well or excavating a mine on the lands above described for twelve (12) months from the rental date. In like manner and upon like payments or tenders, the commencement of drilling operations may be further deferred for like periods successively during the primary term of this lease. All payments or tenders may be made by check or draft of Lessee or any assignee thereof, mailed or delivered on or before the rental date.

5. If during the primary term and prior to discovery of oil, gas, sulphur or other minerals hereunder, Lessee should drill a dry hole or holes on the leased premises, this lease shall not terminate (1) if Lessee commences additional drilling operations within ninety (90) days from the cessation of drilling on said well, or (2) if Lessee resumes the payment or tender of rentals on or before the rental date, if any, next ensuing

* * * *

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AMENDMENT OF OIL, GAS AND MINERAL LEASE

THIS AGREEMENT, entered into by and between Williams, Inc. a Delaware corporation, and Shell Oil Company, a Delaware corporation, hereinafter referred to as Shell,

W I T N E S S E T H, That:

A) WHEREAS, Williams, Inc., a Delaware Corporation, as lessor, granted unto Mrs. Delphine C. Williams, Frank B. Williams, Mrs. Elizabeth Williams Zorthian, Mrs. Leila Moors Williams, L. Kemper Williams, Mrs. Katharine Williams Tremaine, Laurence M. Williams, and Mrs. Lucille Williams Mayfield, as lessee, a certain oil, gas and mineral lease dated July 24, 1952, not yet recorded, covering and affecting the following described land situated in Terrebonne Parish, Louisiana, to-wit:

> 20 acres, more or less, out of Section 36, T-17-S, R-15-E, more particularly described as follows:
>
> Beginning at a point in the northerly boundary of said Section 36, at the most westerly corner of Section 17, said township and range; thence with the common line between said Sections 17 and 36 south 56 degrees 53 minutes east 924 feet to the most southerly corner of said Section 17, being a point at the northwesterly line of Section 16, said township and range; thence south 33 degrees seven minutes west at 315.4 feet passing the most westerly corner of Section 16, 942.9 feet to a corner; thence north 56 degrees 53 minutes west 924 feet to a corner; thence north 33 degrees seven minutes east at 878.3 feet passing the most southerly corner of Section 18, 942.9 feet to the point of beginning, containing 20 acres, more or less;

and

B) WHEREAS, the above named lessees assigned and transferred the above described lease to Shell Oil Company, which is now the holder and owner, as lessee, of said lease; and

C) WHEREAS, Shell desires Williams, Inc., to approve the assignment of said lease to Shell; and

D) WHEREAS, it is now the mutual desire of Williams, Inc., as lessor, and Shell Oil Company, as holder and owner of said lease, as lessee, to amend said lease in certain particulars;

NOW, THEREFORE, it is hereby agreed:

1. The assignment to Shell described in Preamble B hereof of the oil, gas and mineral lease described in Preamble A hereof is hereby approved and the leasehold rights of Shell in said lease are hereby recognized by Williams, Inc.

2. The oil, gas and mineral lease described in Preamble A hereof is hereby amended as follows:

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> (a) The royalty provisions of said lease are hereby amended so that wherever a royalty fraction of one-sixth (1/6) is provided for, such fraction is hereby changed and amended to read "one-fourth (1/4)".
>
> (b) The provisions of Section 11 of said lease are hereby amended so that wherever the fraction one-sixth (1/6) appears such fraction is hereby changed and amended to read "one-fourth (1/4)"; and wherever the

fraction five-sixths (5/6) appears, such fraction is hereby changed and amended to read "three-fourths (3/4)".

(c) Paragraph 18 of said lease is amended to provide that units pooled for the production of gas and condensate shall not substantially exceed 320 acres, rather than 160 acres as is presently provided in said lease;

(d) There is hereby added to said lease the following paragraph numbered 20, which shall supersede any provisions of the lease in conflict therewith;

"Lessee shall commence operations on or before the 15th day of January, 1956, for the drilling of a well on the leased premises and shall drill such well with due diligence until it reaches a total depth from the surface of 9300 feet unless such well encounters oil in paying quantities at a lesser depth, or in default thereof, said lease shall terminate as to oil and all lessee's rights as to oil under said lease shall cease and terminate. Oil shall include any fluid hydrocarbons produced from an oil well as here defined. For the purpose of this section "Oil Well" is defined as any well producing hydrocarbon fluids from a subsurface formation and a portion of all of which said fluids occur under existing reservoir conditions as a liquid in the subsurface formation from which produced, and from which well hydrocarbon liquids are produced with a ratio not exceeding 17,500 cubic feet of gas per barrel. In the event the well herein provided for is unable to reach the depth herein specified because of mechanical condition or because of encountering formations through which, in Shell's opinion, it is impractical to drill, then Shell shall have the right to start a substitute well within 60 days after abandonment of the first and the substitute well shall be considered the same as the first well for all purposes of this agreement."

Except as herein amended, said oil, gas and mineral lease remains in full force and effect as to all of its terms and provisions as originally written.

This instrument is binding on all who sign, their successors and assigns.

THUS DONE AND SIGNED on this 24th day of January, 1955, in the presence of the undersigned competent witnesses.

WITNESSES: WILLIAMS, INC.

.... By ....

SHELL OIL COMPANY

....

.... By ....

* * * *

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October 9, 1975

Ms. Sharon G. Province
Commission Staff Counsel
Federal Power Commission
825 North Capitol Street, N.E.
Washington, D.C. 20426

Re: Docket No. RI76-8
Pennzoil Producing Company
Docket No. RI76-10
Shell Oil Company

Dear Ms. Province:

In accordance with the ruling of Judge Samuel Z. Gordon at pages 92-93, and 123 of the Transcript, Shell Oil Company submits the following answers to the interrogatories posed by you in your letter of October 3, 1975. We have agreed by telephone that a map of the operating units in which the two Williams leases are contained will be submitted for the record, and this map will be a partial answer to Questions 1 and 2 and a complete answer to Questions 3 and 9. We believe this map, attached hereto as Appendix A, should be filed as an Exhibit in this proceeding, and request the Administrative Law Judge to admit it as evidence.

The answers to your questions are as follows:

1. (a) D_2 RA SUB
   (b) EE_6 RA SU
   (c) EE_6 RA SUA
   (d) FF RA SUA
   (e) KK RA SUA
   (f) LL RA SUB

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   (g) O SUH
   (h) O SUR
   (i) O SUS
   (j) Y RA SUA

2. (a) D_2 RA SUB
   (b) EE_6 RA SUA
   (c) O SUR
   (d) Y RA SUA

3. See map attached as Appendix A.

4.

Units	Shell's Working Interest — Percentage		
	1934 Lease	1952 Lease	Total
(a) D_2 RA SUB	10.06	2.33	12.39
(b) EE_6 RA SU	0.85	—	0.85
(c) EE_6 RA SUA	3.76	2.47	6.23
(d) FF RA SUA	4.39	—	4.39
(e) KK RA SUA	0.05	—	0.05
(f) LL RA SUB	0.04	—	0.04
(g) O SUH	5.00	—	5.00
(h) O SUR	26.48	5.65	32.13
(i) O SUS	0.42	—	0.42
(j) Y RA SUA	0.08	1.38	1.46

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5. Yes.

6.

Units	Total Gross Oil/Condensate Production — MBBL
(a) D_2 RA SUB	3.8
(b) EE_6 RA SU	—
(1) Southdown No. 1	68.6
(2) Gilbert No. 1	52.5
(c) EE_6 RA SUA	—
(1) R.O.B. No. 40	70.3
(2) Pelican No. A-7	59.4
(d) FF RA SUA	25.5
(e) KK RA SUA	16.8
(f) LL RA SUB	53.1
(g) O SUH	4.1
(h) O SUR	7.0
(i) O SUS	11.9
(j) Y RA SUA	25.1

Note: Except for EE_6 RA SU and EE_6 RA SUA, there is only one well producing on each unit. In order to obtain Shell's Working Interest share of the total gross production, the percentage of Work-Interest shown in the answer to Question 4 should be multiplied by the total production shown.

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7.

Units	Oil/Condensate Unit Value — Dollar/BBL
(a) D_2 RA SUB	8.91
(b) EE_6 RA SU	7.03
(c) EE_6 RA SUA	9.46
(d) FF RA SUA	5.94
(e) KK RA SUA	5.52
(f) LL RA SUB	7.71
(g) O SUH	5.36
(h) O SUR	5.56
(i) O SUS	10.77
(j) Y RA SUA	10.35

8.

Units	Shell Sales — MMCF 30.1125¢	31.1125¢	58.8595¢	59.8855¢
(a) D_2 RA SUB	23.8	47.9	—	—
(b) EE_6 RA SU	8.1	5.9	10.2	5.7
(c) EE_6 RA SUA	139.8	57.5	136.3	62.4
(d) FF RA SUA	45.3	16.6	—	—
(e) KK RA SUA	0.3	—	0.6	0.3
(f) LL RA SUB	0.5	—	1.2	0.6
(g) O SUH	6.0	—	10.5	3.8
(h) O SUR	399.0	134.0	—	—
(i) O SUS	1.3	—	3.0	1.5
(j) Y RA SUA	0.3	—	0.6	0.3

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8. Note: The total of the above volumes does not include Shell's interest in the dissolved gas on acreage included in the original 1934 Lease, and hence is "unitized" with other lease production by law. This production was not attributable to the above units. These volumes, totalling 179 MMCF, were included in the first answer on page one of John F. Bruskotter's Supplemental Testimony.

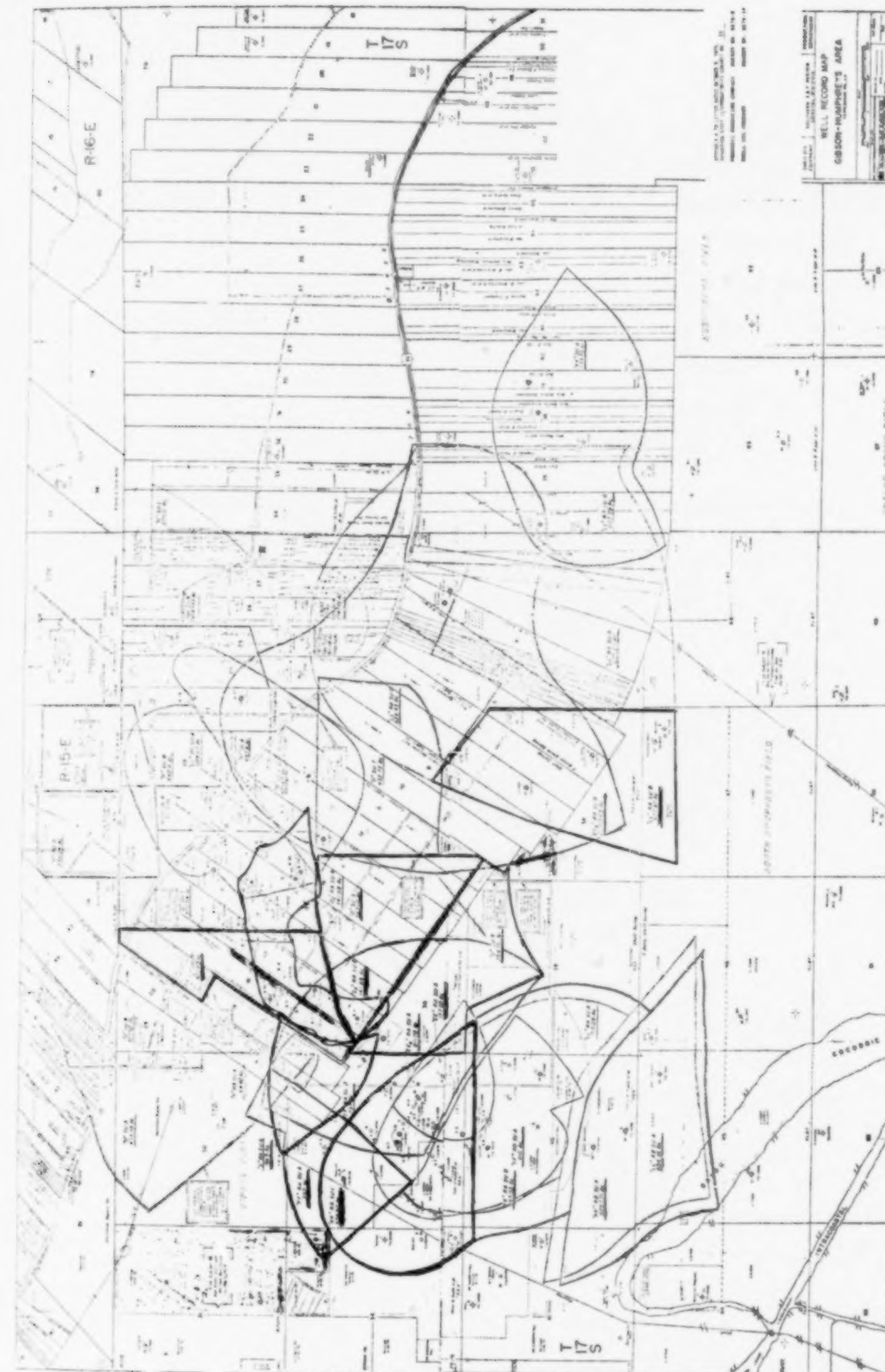
9. See map attached hereto as Appendix A.

Very truly yours,

T. G. JOHNSON
Thomas G. Johnson
Attorney for Shell Oil
Company

cc: Administrative Law
Judge Samuel Z. Gordon
Federal Power Commission
825 North Capitol Street, N.E.
Washington, D.C. 20426

All Parties



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October 6, 1975

Honorable Samuel Z. Gordon
Administrative Law Judge
Federal Power Commission
825 North Capitol Street
Washington, D.C.

Re: Pennzoil Producing Comapny
Docket No. RI 76-8;
Shell Oil Company, Docket
No. RI 76-10

Dear Judge Gordon:

At the hearing held in the above referenced docket on September 23, 1975, Mr. A. Duncan Gray, Jr. testified on behalf of Pennzoil Producing Company. A portion of his testimony concerned calculations based on volumes of production. As a result of an effort to update the numbers involved, it was discovered that the volumes upon which the calculations had been based were in error. The enclosed affidavit of Mr. Gray sets forth the necessary corrections.

Very truly yours,

STEPHEN M. HACKERMAN
Stephen M. Hackerman

SMH:120
enclosure
cc: All Parties of Record

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AFFIDAVIT

THE STATE OF TEXAS }
COUNTY OF HARRIS }

A. Duncan Gray, Jr., being duly sworn, deposes and says:

I have previously testified in Pennzoil Producing Company and Shell Oil Company, Docket Nos. RI 76-8 and 76-10. That testimony appears at pages 23-42 of the transcript in that proceeding. Included in that testimony were a number of calculations based on Producing's production volumes. Subsequent to the date on which this testimony was taken, Producing undertook to update the data upon which the calculations were based. As a result, it was discovered that a number of the original calculations were based on incorrect volumes. The following corrections are therefore necessary:

1. On page 26, line 48, reference is made to the fraction of gas sold by Producing from the Williams lease which qualifies for the national new gas rate under Opinion No. 699-H. That fraction is roughly one-half rather than one-third. This same correction should also be made at page 38, line 12-13.

2. On page 27, line 11, reference is made to the price increase per Mcf for volumes delivered from July, 1975 through the end of 1975 if the royalty flow through is approved. That figure for the period July, 1975 through June 1976, is 3.6467¢ per Mcf. In addition the surcharge, if placed into effect on July 1, 1975 will be 6.3291¢ per Mcf rather than 8.645¢ (page 27 line 5), 2.8753 rather than 5.4205¢ of that total attributable to volumes delivered during the first six months of 1975 (page 5, line 13) and 3.4538¢ rather than 3.2252¢ attributable to 1974 deliveries (page 5, line 15).

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In addition at pages 31 and 32, there are a number of references to the average price for gas sold by Producing from the Williams lease under a variety of circumstances, all without Btu adjustment or tax reimbursement. The reference should be to the average price for gas sold by Producing from the Gibson field, without adjustments. These figures are as follows.

1. The current average price is approximately 40.9103¢ per Mcf rather than 36¢ (page 31, line 21). This figure is based on the projected volume of deliveries for the period July 1, 1975 through June 30, 1976 and does not include an adjustment for the 1 cent escalation to be effective January 1, 1976 for new gas sold under Opinion No. 699-H.

2. If the royalty flow through is allowed, the average price would be 44.6¢ per Mcf rather than 44¢ per Mcf (page 31, line 25).

3. The average price if both the flow through and the surcharge is approved would be 50.9¢ per Mcf for the next twelve months and 44.6¢ thereafter rather than 52¢ and 44¢ respectively (page 32, lines 6-7).

A. DUNCAN GRAY, JR.
A. Duncan Gray, Jr.

SUBSCRIBED AND SWORN TO, before me, this 6th day of October, 1975.

MARY SCHRAAK FORESTER
Notary Public in and for
Harris County, Texas

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Pennzoil Producing Company

Docket No. RI76-8

Shell Oil Company

Docket No. RI76-10

PRESIDING ADMINISTRATIVE LAW JUDGE'S INITIAL DECISION DENYING PETITIONS FOR SPECIAL RELIEF OR, IN THE ALTERNATIVE, FOR ABANDONMENT

(November 24, 1975)

* * * * *

Administrative Law Judge Gordon, presiding:

1

STATEMENT AND PROCEDURAL BACKGROUND

Shell Oil Company (Shell) and Pennzoil Producing Company (Pennzoil) sell gas produced from the Gibson Field, Terrebonne Parish, Louisiana, to United Gas Pipe Line Company (United) under their FPC Rate Schedules Nos. 202 (Shell) and 234 (Pennzoil). A portion of the gas sold by Shell to United is produced from acreage covered by a mineral lease dated August 29, 1934 (the 1934 lease, Ex. 9) from F. B. Williams Cypress Company (now Williams, Inc.) to Shell Petroleum Company (now Shell), and by a mineral lease dated July 24, 1952 (the 1952 lease Ex. 10) from Williams, Inc. to certain persons who assigned the lease to Shell in January 1955. This assignment was

approved by Williams, Inc. on January 24, 1955 (Ex. 10, pp. 30-31). A portion of the gas sold by Pennzoil to United is produced from a part of the 1934 lease acreage which was subleased by Shell to Union Producing Company (now Pennzoil) on December 29, 1942. Certain acreage from the 1934 lease has been unitized.

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The 1934 and 1952 leases and the royalty demands of the lessor, Williams, Inc., thereunder, give rise to the issues in this proceeding.

The 1934 lease provides for payment of royalty on the gas produced thereunder equal to "one-eighth (1/8) of the value thereof, calculated at the market rate prevailing at the well" (Ex. 9, sec. 4). The 1952 lease, as amended on January 24, 1955, provides for payment of royalty on the gas produced thereunder equal to "one-fourth (1/4) of the value thereof, calculated at the market price prevailing at the well" (Ex. 10, sec. 3; Amendment of January 24, 1955, Ex. 10).

By letters dated June 7, 1973 (Ex. 1) and March 27, 1974 (Ex. 2), Williams, Inc. demanded payment by Shell and Pennzoil of royalties based on market values ranging from 35 cents to 70 cents for the period from October 1, 1971 through December 31, 1973, and at the 70 cent price thereafter — all of which prices exceeded the ceiling rates which had been established by the Commission for the Southern Louisiana Area, of which the Gibson Field is a part. By letter of June 5, 1974 (Ex. 3) Williams, Inc. declared that the 1934 and 1952 leases were terminated for non-payment of proper royalties.

Prior to receipt of Williams' June 5, 1974 letter, Shell and Pennzoil, on May 24, 1974, filed a petition in the Civil District Court in the Parish of Orleans, Louisiana (*Shell Oil Company and Pennzoil Producing Company v. Williams, Inc., et al.*, Docket No. 573-591) praying for a judgment declaring that Shell and Pennzoil were paying the appropriate royalty and for a preliminary injunction, pending disposition of the suit, to enjoin Williams, Inc. from taking any efforts to interfere with Shell's and Pennzoil's possession and operation of the leased properties. Such a preliminary injunction was granted (see Ex. 3). By Reconventional Demand (counterclaim) Williams requested *inter alia*, cancellation of the 1934 and 1952 leases, effective June 5, 1974, payment of the value of all oil, gas and minerals extracted from the properties after said dates, and payment of damages from Shell and Pennzoil in excess of $1.5 million for alleged past underpayment of royalties (Ex. 5). The asserted underpayment was calculated on the basis of market prices ranging from 35 cents to 70 cents per Mcf for the period from October 1, 1971 through May 31, 1974. Williams, Inc. amended its reconventional demand on June 27, 1975 to request

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damages of almost $1,990,000 from Pennzoil and almost $198,000 from Shell covering alleged royalty underpayments from June 1, 1974 through April 30, 1975 on the basis of market prices ranging from $1.30-$1.40 per Mcf for the period from June 1, 1974 through April 30, 1975 (Ex. 6).

Shell, Pennzoil and Williams, Inc. have entered into a Settlement Agreement dated June 18, 1975 (attached to Shell's Petition as Appendix A) which will terminate the litigation and permit Shell and Pennzoil to retain both the 1934 lease and the 1952 lease upon the payment of higher royalties to Williams, Inc. or, in the alternative, upon abandoning to Williams of the royalty interests in the gas. The Settlement Agreement provides that Shell and Pennzoil will make such applications to the Federal Power Commis-

sion as may be necessary to obtain authorization for the following:

(A) Payment by Shell and Pennzoil of royalty on each Mcf produced and sold under the 1934 lease and under the 1952 lease, equal to one-eighth (1/8th) in the case of the 1934 lease and one-fourth (1/4th) in the case of the 1952 lease, of the total of:

(1) the higher of (a) the base royalty rate, or (b) the base alternative rate, plus

(2) seven (7) cents or the full amount of the Louisiana severance tax, which amount is to be increased as the severance tax of the State of Louisiana is increased, plus

(3) the full amount of Federal taxes imposed upon Williams, Inc., plus

(4) any upward or downward adjustment for Btu content of the gas containing more or less than 1,000 Btu per cubic foot, and

pass through to United of the portion of such total which exceeds current royalty payments by Pennzoil and Shell to Williams, Inc.

In connection with the above, "base royalty rate" is 78 cents per Mcf as of January 1, 1975, increasing 1.5 cents per Mcf each January first beginning January 1, 1976, "Base alternative rate" is 150 percent of the highest area or national rate permitted or, in the case of deregulation of interstate gas sales, is the average of the three (3) highest prices provided in sales for resale in the Southern Louisiana Area; or, in the alternative,

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(B) Abandonment of that share of the gas sold under said leases which is attributable to Williams, Inc. royalty interests (i.e., 1/8 and 1/4 of the gas produced under the 1934 and 1952 leases, respectively), said share to be delivered to Williams, Inc. in kind for use or sale in any market.

In addition, the Settlement Agreement provides that Shell and Pennzoil shall pay to Williams, Inc. the sum of the royalty which would have been paid during 1974 if Shell's and Pennzoil's sales price during such period had been 45 cents per Mcf, less royalty actually paid (but only to the extent that the Commission permits Shell and Pennzoil to recover such amounts from United), plus the royalty due if the Commission approves (A) above, all as more fully set out in Section II of the Settlement Agreement attached to Shell's Petition as Appendix A.

United has expressed its agreement to the Settlement Agreement by consenting, upon Commission approval, to amending its gas purchase contracts with Shell and Pennzoil to pay the increased rates called for by the Settlement Agreement or, in the alternative to release one-eighth of the gas if the abandonment to Williams, Inc. is authorized by the Commission (Exs. 7, 8, Tr. 52-57).

Thereafter, and pursuant to the terms of the Settlement Agreement, on July 1, 1975 and July 18, 1975 Pennzoil and Shell, respectively, filed the instant petitions, Docket Nos. RI76-8 and RI76-10, seeking special relief from the just and reasonable rates established under Opinion Nos. 598 and 699 in order to flow through to United the higher royalty rates called for in the Agreement or, in the alternative, if said relief is denied, to abandon to Williams, Inc. one-eighth of the gas produced under the 1934 lease and one-fourth of the gas produced under the 1952 lease. In addition,

Pennzoil and Shell seek approval to impose a retroactive surcharge, as provided for in the Settlement Agreement, against United for gas deliveries made from January 1, 1974 to the effective date of the Commission's order. The petitions seek Commission action no later than February 1, 1976, the date on which, failing favorable action by the Commission upon the petitions, Shell, Pennzoil or Williams, Inc. may terminate the Settlement Agreement. In view of this time limitation, the petitions sought expedited procedures, including waiver of the initial decision.

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In its order issued August 29, 1975, the Commission found "[t]here is no justification for allowing a producer to pass through higher royalty costs to the consumer without a showing that Petitioners' overall costs are higher than those reflected in our Opinion No. 699-H" (Order, p. 3) and thereupon denied "[t]hose portions of the petitions... relating to a request for rate increases due to increases in royalty payments" (Order, p. 4). Finding that "[t]here is no basis for allowing a temporary surcharge for the purpose of permitting a producer to recover retroactive royalty payments" (Order, p. 3), the Commission denied those portions of the petitions relating to the surcharge (p. 4). The Commission set down for hearing and decision the sole issue of the requested abandonment of the royalty owners' interests in the gas, and consolidated the two petitions for this purpose (Order, pp. 3, 4). The Commission denied the request for waiver of the initial decision, but directed that the same be filed on or before November 26, 1975, with the hearing to commence on September 23, 1975.

Thereafter, on September 9, 1975, Pennzoil filed an application for rehearing of the August 29 order, pointing out that the Commission's summary denial, without a hear-

ing, of its request for special relief on the market value royalty issue was inconsistent with Commission action in other cases, and constituted unlawful discrimination against it. Pennzoil stated it "does not contend that the orders issued in the *Huffington* and *Exxon* cases establish the propriety of the rate increase based on increased royalties which Pennzoil seeks in this case. That can only be established by the presentation of evidence. Without question, however, the *Huffington* and *Exxon* orders do establish Pennzoil's right to present the evidence which will justify the rate increase request." (Application for rehearing, p. 4.)

In its order issued on September 22, 1975 the Commission recognized that Pennzoil's rate increase request based on higher market value royalty payments presented similar issues to those raised in *Huffington* (Docket No. CI75-602) and since an evidentiary hearing had been set in that case, the same treatment should be afforded here. Accordingly, the Commission granted Pennzoil's application for rehearing, applied the same ruling (on its own motion) to Shell, and vacated "[t]hat portion of the August 29, 1975 order denying Pennzoil's and Shell's petitions for special relief." The Commission did not, however, vacate that portion of its August 29 order denying the petitions'

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requests to impose a temporary surcharge based on past royalties. Since the Commission did not change the scheduled date for the hearing, which was set for September 23, it provided in its September 22 order that Shell should be afforded such additional time as might be fixed by order of the Presiding Administrative Law Judge for filing any additional testimony and evidence relating to its request for authorization to collect increased rates. No similar dispensation was made for Pennzoil since it had

represented that it had already submitted such evidence in its petition for special relief.

The hearing was held on September 23, 1975, at which time Shell, Pennzoil and United adduced the testimony of witnesses and presented documentary evidence. Shell was afforded additional time to present certain factual data as to prices, volumes and costs, and it presented such material for the record under covering letter dated September 26, 1975 (Additional Prepared Testimony of John F. Bruskotter, received in evidence as late-filed Exhibit 10). Shell was to file any additional cost data which it might wish to submit for the record by October 3, and, if it did so, a further hearing would be held on October 8 (Tr. 121-2). However, Shell advised that it did not intend to file any additional cost data (Additional Prepared Testimony of John F. Bruskotter, p. 3 (Ex. 10). Certain of the data filed by Shell after conclusion of the hearing on September 23 provoked some questions by the Staff, and, pursuant to arrangements made at the hearing, Staff filed written interrogatories directed to Shell on October 3 (late-filed Ex. 11(a)). Shell's written answers to said interrogatories were filed on October 10, 1975 (late-filed Ex. 11). On October 6, 1975, Pennzoil filed an affidavit by its witness A. Duncan Gray, Jr. correcting certain of his testimoney as to prices, volumes and dollar effects of the requested royalty increases (late-filed Ex. 13).

Initial briefs and reply briefs were mailed on or about October 21 and October 28, 1975, by the parties and certain of the intervenors.

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II

THE ISSUES

The issues are:

1. Whether Pennzoil and Shell have met their burden of establishing they are entitled to special relief from the area (Opinion 598) and nationwide (Opinion 699-H) just and reasonable rates established by the Commission because, pursuant to an agreement entered into with the lessor for settling pending litigation in the state court involving the lessor's claim to payment of royalties based on market values in excess of the Commission's ceiling rates, their royalty costs will be increased, in the absence of their establishing that their overall costs of producing gas from the acreage in question will exceed the ceiling rates or that their out-of-pocket expenditures will exceed revenues. Implicit in this issue is the question of what are the legal standards governing the granting of such special relief.

2. Whether, failing the grant of the requested special relief, Pennzoil and Shell have met their burden of establishing that abandonment of the royalty owner's share of the gas is authorized by the present or future public convenience and necessity, where such abandonment is called for, as an alternative, in the aforesaid settlement agreement.

3. Whether assuming *arguendo* that the issue of a surcharge for past royalties is still open under the Commission's orders herein, such a surcharge may be lawfully and properly imposed by Pennzoil and Shell against United when to do so would, in effect, impose a retroactive increase above area and nationwide ceiling rates.

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III

PENNZOIL AND SHELL ARE NOT ENTITLED TO SPECIAL RELIEF FROM THE AREA AND NATIONWIDE CEILING RATES ESTABLISHED BY THE COMMISSION

In essence, the proposed Settlement Agreement of June 18, 1975, entered into between the producers-lessees, Pennzoil and Shell, and the lessor, Williams, Inc., provides that royalties will be computed on the basis of 78 cents per Mcf (plus 1.5 cents per Mcf for each year beginning January 1, 1976), that Shell and Pennzoil will pay Williams one-eighth of that amount for gas produced under the 1934 lease, and that Shell will pay Williams one-fourth of that amount for gas produced under the 1952 lease (Pennzoil is not a lessee or sub-lessee under the 1952 lease and has no royalty obligation thereunder). Pennzoil and Shell seek permission herein to obtain from the gas purchaser, United, higher prices than the Commission-established ceiling area rates (Opinion No. 598) and nationwide rates (Opinion No. 699-H) in order to flow through, on a cents-for-cents basis, the higher royalty payments which they would be making to Williams pursuant to the Settlement Agreement. United has agreed, upon Commission approval, to pay such higher prices. Either Williams or Pennzoil and Shell, acting together, has the option, under the terms of the Agreement to terminate the same if the Commission, by February 1, 1976, does not authorize the special relief herein requested as to future royalty flow through (discussed in Section III) or the abandonment alternative (Section IV, *infra*). No such option to terminate the Settlement Agreement is retained if the Commission refuses to approve the surcharge (Settlement Agreement, Section VIII A; Section V, *infra*).

Of course, if Pennzoil and Shell prevailed in the state court litigation and it were held that the "market value" did not exceed the Commission's established ceiling prices, this would end the matter since Williams would not be entitled to any higher royalties than that paid to it and Pennzoil and Shell would not be seeking any special relief from the ceiling prices in order to pay Williams any greater royalties.

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A. *Position of Pennzoil and Shell*

Pennzoil and Shell have testified that they view the state court litigation seriously and, while they have not attempted to measure their chances of prevailing on the merits, they have sought to eliminate the risks of the litigation by entering into the Settlement Agreement.[1] The Agreement, they argue, is just and reasonable and in the public interest because (a) the 78 cent price for computing royalties is less than the intrastate price which ranges from $1.10 to $1.58 per Mcf (Tr. 63, 64), (b) the higher rates requested by way of special relief in order to flow through the higher royalty costs would amount, in the case of Shell, to 3.6 cents per Mcf under the 1934 lease and 9 cents per Mcf under the 1952 lease (based on Shell's average prices in the year ended April 1, 1975 — Additional Prepared Testimony of Bruskotter, pp. 1-2, Ex. 10), and, in the case of Pennzoil, would amount to 3.6 cents per Mcf (based on projected volumes from July 1975 through June 1976 — Affidavit of Gray, Ex. 13)[2] and (c) implementation of the

[1] Apart from anything else, the settlement would extinguish, at no cost to Pennzoil and Shell, Williams' claims for damages for alleged underpayment of past royalties amounting to approximately $1,990,000 against Pennzoil and approximately $198,000 against Shell.

[2] The above data both for Shell and Pennzoil do not reflect any price increases for the surcharge, which, in the case of Pennzoil, would amount to 6.33 cents per Mcf for one year (Affidavit of Gray, Ex. 13). No data as to the Shell surcharge amount were presented.

settlement would permit Shell and Pennzoil to retain both leases and avoid any diversion of gas from the interstate market.[3]

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In contrast, if Williams prevailed in the state court litigation, Pennzoil and Shell argue that this might result in the leases being cancelled and, if Williams were then free to sell the gas in any market, a diversion of all the gas from the interstate market. Even if Williams still had to sell the gas in the interstate market, he might be able to sell it at the small producer rate of 130% of the nationwide rate, or he could sell all the gas at the nationwide rate — prices, which, in either event, are higher than the prices resulting from the settlement. Furthermore, if Williams won in the state court on his claim that market value meant prices in excess of the Commission ceilings, but the court did not decree lease cancellation, Pennzoil and Shell would have to pay royalties based on $1.40 or more per Mcf or above and such higher costs (plus damages for past underpayment of royalties) might then have to be passed on to their customer, United.

Finally, Pennzoil and Shell urge that the Settlement Agreement with Williams should be implemented since it will remove the cloud of litigation and thus will enable them to proceed with development plans on the leases.

B. *Reasons for Denying Special Relief*

The foregoing arguments and position of Shell and Pennzoil have certain attractions but they suffer from some basic flaws, many of which are pointed out by the Commission Staff and by intervenor, Michigan Pipe Line Company, in their briefs.

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[3] United generally supports the position of Shell and Pennzoil.

First, the law is clear, both from Commission and court decisions, that a producer seeking special relief from area or nationwide prices based on asserted increased costs must establish that his overall costs incurred in the operation of the particular well or group of wells are higher than the applicable Commission-established area or nationwide ceiling rates, or, even more stringently, that his out-of-pocket expenses will exceed revenues. *Permian Basin Area Rate Proceedings*, 34 FPC 159, 226 (1965), affirmed, *Permian Basin Area Rate Cases*, 390 U.S. 747, 770-773 (1968): Opinion 598 (Southern Louisiana Area rates), mimeo at 70, 18 CFR § 154.105(j), affirmed, *Placid Oil Company v. Federal Power Commission*, 483 F.2d 880, 910-911 (5th Cir., 1973), affirmed *sub nom. Mobil Oil Corp. v. Federal Power Commission*, 417 U.S. 283, 328 (1974); Opinion 699 (Nationwide Area rates), mimeo 105-106, 18 CFR 2.56a(g), affirmed, *Shell Oil Company v. Federal Power Commission*, Nos. 74-3330 et al. F.2d (5th Cir., October 14, 1975) slip. at 168; *McDonald v. Federal Power Commission*, 505 F.2d 355 (C.A.D.C. 1974).

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cert. denied sub. nom., *George Mitchell and Associates, Inc. v. Macdonald*, 421 U.S. 912 (1975); *Consumers Union of U.S., Inc. v. Federal Power Commission*, 510 F.2d 656, 660 (C.A.D.C., 1975); *Terra Resources, Inc.*, 51 FPC 876 (1974); *Continental Oil Company*, Docket No. RI74-108, order of May 15, 1974; *Ashland Oil, Inc.*, Docket No. RI74-40, Order of May 15, 1974.

Thus, in Opinion 699 (June 21, 1974) the Commission pointed out that its previous area rate opinions provided for special relief in unusual circumstances where the area rate was not sufficient to recover the cost of producing natural gas already dedicated to the interstate market. The Commission stated (mimeo at 105-106):

"Without attempting to enumerate all circumstances which would form an adequate basis for granting special relief, we shall grant special relief where the producer can demonstrate that the out-of-pocket expenses incurred in the operation of a particular well (or group of wells) are greater than revenues from the sale of the subject gas. See, *Permian Basin Area Rate Cases*, 390 U.S. 747, 770-773.

"It is incumbent upon the producer seeking special relief to prove by his books and accounts that the operating expenses are in excess of the revenues earned from the sale of the gas from such well or wells.

"There are also other avenues of extraordinary relief for a producer who may be adversely affected by the rate established in this proceeding. Where a producer has already dedicated gas to the interstate market and a change in circumstances makes continued production uneconomical, the producer

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may seek relief under our Order No. 481,[144] or Order No. 482,[145]. Where the producer has not already committed the subject acreage of gas supply to the interstate market, he may seek certification of the sale under Order No. 455." [18 CFR § 2.75; Optional Procedure for Certificating New Producer Sales of Natural Gas]

[144] 18 C.F.R. § 2.76; *Policy with Respect to Sales Where Reduced Pressures, Need for Reconditioning, Deeper Drilling, or Other Factors Make Further Production Uneconomical at Existing Prices*, Docket No. R-458, 49 F.P.C. 992 (1973), as amended by *Order Amending Order No. 481 and Granting and Denying Petitions for Rehearing*, 49 F.P.C. (June 8, 1973).

[145] 18 C.F.R. § 2.77; *Flaring and Venting of Natural Gas*, Docket No. R-459, Order No. 482, 49 F.P.C. 996 (1973)."

In *Macdonald* v. *FPC, supra*, the court remanded the Commission's decision approving a settlement agreement granting special relief from area rates for "reconsideration of the reasonableness of Mitchell's [the producer's] settlement agreement in light of a full evidentiary record on Mitchell's costs of production in the Wise County contract region and the profits which it can expect to obtain over the life of its new and old wells in this region." (505 F.2d at 365)[4]

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Even under the 2.75 optional procedure,[5] which might be thought to provide more liberal criteria for affording higher than area or nationwide rates as a means to induce new dedications of gas to the interstate market, the court in *Consumers Union of U.S., Inc.* v. *Federal Power Commission, supra*, in remanding the Commission's decision approving higher rates, pointed out that applicants' cost showing was inadequate and stated (at 660): "Even after *Permian* and *Mobil Oil*, it is doubtful that non-cost factors can sustain a decision by the FPC which is unsupported by sound cost data."

In approving the nationwide rates established by the Opinion 699 series of orders, the Court of Appeals in *Shell*

[4] ***Cities of Fulton et al., Missouri* v. *FPC***, 512 F.2d 947 (C.A.D.C. 1975), relied upon by petitioners, is not to the contrary since, *inter alia*, applicant there was not seeking higher than area or nationwide rates and, as pointed out by the court, there were sufficient cost data presented (at 952).

[5] The instant petitions for special relief are not filed under 18 C.F.R. 2.75 (nor 18 C.F.R. 2.76) but under the special relief procedures in the Southern Louisiana Area Rate (18 C.F.R. 154.105) and the nationwide rate (18 C.F.R. 2.56a) orders. Section 2.75 is clearly inapplicable since, among other things, the instant petitions are for rate relief on the gas produced under the Williams' leases from wells commenced long before April 6, 1972 and the gas had previously been sold in the interstate market. Section 2.76 would appear to be inapplicable. See *Terra Resources, supra*.

Oil Company v. *Federal Power Commission*, supra stated (slip. op. at 168):

> "First, the order made provisions for special relief in unusual circumstances where the rate is not sufficient to recover the cost of producing natural gas already dedicated to the interstate market. The burden is on the producer with the above average costs to justify an additional price for its gas. This is not the only avenue of extraordinary relief for producers who may be adversely affected by the national rate structure, however. The FPC has standing regulations which afford relief to producers who face an increase in costs. 18 C.F.R. § 2.76 (1974)."

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The Supreme Court in *Mobil Oil Corp.* v. *F.P.C.*, 417 U.S. 283 (1974) affirmed the Fifth Circuit's affirmance (*Placid Oil Company* v. *Federal Power Commission*, 483 F.2d 880 (1973)) of the Commission's Southern Louisiana Area Rate order, Opinion 598. Both courts specifically addressed the problem of market value royalty lease clauses as affecting area ceiling rates and special relief therefrom. Thus the Supreme Court stated (at 328):

> "Mobil also complains that the Commission failed to provide automatic adjustments in area rates to compensate for anticipated higher royalty costs. It relies on *Mobil Oil Corp.* v. *FPC*, 149 U.S. App. D.C. 310, 463 F.2d 256 (1972) where the Court of Appeals for the District of Columbia Circuit reversed a Commission holding that subjected royalties to FPC administrative ceilings. Mobil argues that under that decision the 1971 rate schedules must take into account the possibility of higher royalty obligations. We agree with the Court of Appeals that Mobil's argument is hypothetical at this stage and that in any event an affected producer is entitled to seek individualized relief. The Court of Appeals said:

> '[W]e are not willing to alter or stay the implementation of area wide rates for the entire industry merely on the basis of what *might* happen to *some* producers' costs *if* [the D.C. Circuit's] statement of the law prevails.
>
> If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief. *Permian* contemplated it.' 483 F.2d. at 911 (emphasis in original)."

On the same matter, the Court of Appeals below had added (*Placid Oil* at 911):

> "If the royalty obligations are such as to make the rates established by Op: 598, and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will certainly have recourse to the administrative process."

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Second, it is plain from the foregoing that petitioners here must prove, as a condition precedent to obtaining special relief from the area and nationwide ceiling rates, that their overall costs with the increased royalty payments will be greater than the ceiling rates or that their out-of-pocket expenditures will exceed revenues. However, Pennzoil and Shell have not met their burden of proof. Pennzoil has made no showing whatever as to its overall costs or out-of-pocket expenditures from operations under the 1934 Williams lease. It has not even attempted to make such a showing. For this reason alone, Pennzoil's petition for special relief must be denied.

Nor is it any answer to Pennzoil's failure to make the requisite cost showing (which would help establish that it is "in a bind" because of the higher royalty payments it may have to make to Williams) for Pennzoil to claim (Tr.

26) that by paying Williams more in royalties it will have that much less to spend on exploration and development. On that basis every gas producer faced with any increased cost of production (whether stemming from higher royalties or increased labor, material or other costs) would be entitled to prices in excess of the Commission ceiling rates. Moreover, Pennzoil has made no firm commitment here to undertake increased exploration and development as a possible *quid pro quo* for a rate increase and has not even attempted to establish projected costs and revenues from any such activity. (See the *Macdonald* and *Cities of Fulton* cases, *supra*). It has merely stated that it has plans in 1976 for one development well and one work-over of an existing well, with reserves of 1.65 Bcf and 2.42 Bcf of gas, respectively, and that these plans will be deferred indefinitely if it had to pay royalties on the basis of $1.40 per Mcf or above while the available price for the gas was 52 cents (Tr. 30-31). Significantly, Pennzoil did not testify that it would defer these plans if royalties were paid on the basis of the 78 cents per Mcf settlement price and the gas price remained at 52 cents.

In contrast to Pennzoil, Shell did make an effort to adduce some evidence as to its costs of operations and revenues under the 1934 and 1952 Williams leases.

Shell asserts that its current operating costs (based on the first five months of 1975) on the two leases are 4.5 cents per Mcf. This is an average cost for the entire Gibson Field and the Williams leases are included in 10 separate operating units in that Field. However, since the Williams leases are representative of the entire Field, the Field average cost is properly allocated to the Williams leases. The 4.5 cents figure includes direct lease cost, reconditioning and recompletion

costs, overhead, and property taxes and insurance. It does not include amortization of capital investment, federal income taxes, return on capital investment, royalties or severance taxes. (Tr. 85, 86, 94, 95, 102-107; Additional Prepared Testimony of Bruskotter, pp. 2, 2a, 3, Ex. 10.) The 4.5 cents figure may be accepted for the purpose of this proceeding since it was not challenged. Although termed an "operating cost" by Shell, it includes more than out-of-pocket expenditures since, at the least, it includes overhead.

However, Shell adduced no testimony as to its capital costs attributable to the Williams leases, although the record was held open for ten days (from September 23 to October 3) for it to do so, and in the event it wished to adduce such cost or other cost data, provision was made to hold a further hearing in the matter on October 8. Shell, however, did not avail itself of this opportunity, and instead sought to use the average nationwide costs embodied in Opinion 699-H, merely "slotting-in" the 4.5 cents figure of its own operating costs and a royalty figure computed on the basis of the $1.40 per Mcf "market value" Williams had claimed.[6]

[6] Shell states that because of the time constraints of this proceeding and the complexities of the Gibson Field with its numerous operating units, reservoirs at different depths, and leases in operation since 1934, it could not, within the limited time, adduce data as to ts capital costs attributable to the Williams leases (Ex. 10, Additional Prepared Testimony of Bruskotter, p. 3; Shell's Initial Brief, pp. 12, 13). However, Shell (and Pennzoil) had requested the accelerated procedure, it had since the filing of its petition in mid-July to prepare for an expected hearing, and, clearly, no one is in as good a position as Shell to establish what are its overall costs, including capital costs. In effect, Shell is making the astonishing claim that it does not know, and cannot ascertain without a superhuman effort, what are its overall costs under the Williams leases which it has been operating since 1934 and 1955.

Such a slotting-in procedure is improper. Since the Opinion No. 699 cost data are based on nationwide averages, there must be very numerous producers experiencing certain costs which are above the nationwide averages, but whose total costs are not. By selecting only their higher cost items and using the other costs reflected in Opinion No. 699, all such

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producers would be entitled to rate increases. This would make a mockery of the nationwide rates. The Commission has rejected such a methodology. "In a case of this nature, *i.e.*, a case wherein special relief from area rates is sought, evidence of area, or national, costs and productivity is inappropriate." (*Continental Oil Company,* Docket No. RI74-108, March 15, 1974.) And clearly, such a method would be contrary to the authorities cited above on the need for adducing individualized cost data to justify special relief. The case of *The Rodman Corporation,* Docket No. CI73-694, relied upon by Shell, is not to the contrary since even in that § 2.75 optional procedure case the Commission relied on project cost studies done by the company's witness, in addition to considering the average nationwide costs. (Opinion No. 736, mimeo p. 4.)

Using the 4.5 cents per Mcf figure for operating costs and other data supplied by Shell as to prices and volumes, the Staff has computed that Shell would earn a yearly profit, without an increase over area and nationwide rates, of $178,951[7] (based on the twelve months ended April 1, 1975) from gas operations under the 1934 and 1952 Williams leases (Staff's Initial Brief, Attachment A; the typographical error in the profit figure ($78,951 should be

[7] The profit of $178,951 does not reflect any capital costs of Shell since, as noted, Shell did not adduce any data as to its own capital costs.

$178,951) was corrected in Staff's Reply Brief, p. 2). This profit assumes that Shell's royalty payments to Williams under the two leases are based on 78 cents per Mcf, the figure which Williams has agreed to accept in the Settlement Agreement.

The foregoing calculations are proper and sustained by the evidence in this proceeding.

In addition, the Staff has calculated, on the basis of data supplied by Shell, that Shell's annual condensate revenues attributable to the two Williams leases would amount to $112,664 (Staff's Initial Brief, Attachment B). These figures were not challenged by Shell and they are accepted herein as in accordance with the evidence in this proceeding. Thus, in addition to an annual profit (exclusive of capital costs) of $178,951 earned

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by Shell from gas operations attributable to the Williams leases, without any price increases above the area and nationwide rates, and assuming royalties were calculated on the basis of the 78 cents Settlement Agreement figure, Shell would also earn $112,664 in yearly revenues from condensate sales attributable to those leases.[8]

Patently, at the 78 cents per Mcf royalty basis agreed to in the Settlement, Shell would be recovering considerably more than its out-of-pocket expenses at the area and nationwide ceiling rates.[9] Hence, Shell's petition for special relief must be denied. If the test for special relief is that Shell must be permitted to recover its overall total costs

[8] Condensate revenues are properly a credit against gas production costs (see Opinion No. 699, mimeo pp. 91-92).

[9] Shell asserts (Initial Brief, p. 8) that if Williams won the state lawsuit (i.e., if royalties are computed on the basis of $1.40 per Mcf), Shell's net revenue on the 1934 lease would be 10.875 cents per Mcf (with no allowance for capital costs) and that it would

(including capital costs), Shell's petition for special relief must be denied because it has failed to sustain its burden of establishing that its overall total costs exceed the area and national rates.

Shell's contention that royalties must be based on the \$1.40 per Mcf claimed by Williams, rather than on the 78 cents per Mcf which Williams has agreed to in the Settlement Agreement, is rejected. For Williams has formally agreed to accept the 78 cents figure as the basis for computing its ⅛ or ¼ royalty share in full settlement of its claims in the state court litigation. Williams is not concerned with whether

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Shell (or Pennzoil) can flow through the higher royalty payments to United and on this score the petitions' requests for special relief to permit the flow through are solely for the benefit of Shell and Pennzoil. Thus, if the Settlement Agreement is terminated because of failure to grant the requested special relief royalty flow-through, it will be at the choice of Shell or Pennzoil, not Williams. But even at a \$1.40 per Mcf royalty base, Shell has shown that it will recover \$55,850 a year more than its out-of-pocket costs (Shell's Reply Brief, Appendix A), to which should be added \$112,664 a year in condensate revenues (Staff's Initial Brief, Attachment B). (This comes to a total of \$168,514 in net annual revenues to Shell, the figure cited by Shell in its Reply Brief, p. 7.)

suffer a net loss of 3.15 cents per Mcf on the 1952 lease (with no allowance for capital costs). On the basis of 78 cents per Mcf in the Settlement, these figures would translate to 18.625 cents per Mcf net revenue on the 1934 lease and 12.35 cents per Mcf net revenue on the 1954 lease. (On the 1934 lease royalty costs would be ⅛ of 78 cents rather than ⅛ of \$1.40; on the 1952 lease, royalty costs would be ¼ of 78 cents, rather than ¼ of \$1.40.)

Third, Shell's contention that special relief should be granted to permit the increased royalty flow-through to United since otherwise it will have less funds to expend on exploration and development, is rejected for reasons stated above in connection with Pennzoil's similar contention. Moreover, it should be noted that Shell has made no commitment to engage in additional exploration and development should the requested relief be granted. Shell had planned to drill a new well on the 1934 Williams lease, but it was the "cloud" of the Williams litigation which delayed the work. The most Shell would say is that "if, as and when the cloud of this litigation is removed, Shell will reevaluate the feasibility of drilling this well." (Tr. 79.)

Fourth, the fact that the instant petitions for special relief come before the Commission in the garb of an agreement between producers and lessor in compromise settlement of the state court litigation, does not entitle the petitions to any greater weight. For while the Commission as well as the courts favor compromise settlements to end litigation, the Settlement Agreement here is merely the beginning point rather than the conclusion of analysis. For the ultimate question is whether Pennzoil and Shell can absorb the increased royalty costs resulting from the settlement or whether they must have special relief from the area and nationwide ceiling rates in order to pass on the increased costs to their customer, United. The same question would be posed if the state court had decreed on the merits that royalties must be calculated on the basis of 78 cents per Mcf or \$1.40 cents or some other figure. And, as we have seen, this question must be decided adversely to Pennzoil and Shell.

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Fifth, in requesting special relief to flow through increased royalty costs, even absent the establishing of cost

justification, Pennzoil and Shell are in effect requesting an automatic flow-through of increased royalty costs in the same fashion as, for example, state production taxes. To grant such a request could lead to an avalanche of similar special relief requests and could negate the established area and nationwide rates. Both the Commission and the courts have rightly refused to permit such a result. The Supreme Court in *Mobil, supra* (517 U.S. at 328) has specifically rejected the notion of an automatic flow-through of higher royalty costs. Moreover, if an automatic flow-through of increased royalty costs is permitted, it has not been demonstrated here why a similar flow-through should not be permitted for other costs which are not controlled by the Commission, e.g., the producers' labor and material costs.[10]

Sixth, the dire results envisaged by Pennzoil and Shell from the state court litigation are, of course, speculative. It is highly doubtful that Williams would prevail on its claim that "market value" for basing royalty payments means a price in excess of the Commission-established area and nationwide ceiling prices. While holding that the Commission lacked jurisdiction to regulate the royalty prices paid by producers to lessors, the Court of Appeals in *Mobil Oil Corporation* v. *Federal Power Commission,* (463 F.2d 256 (C.A.D.C., 1972), cert. den. 406 U.S. 976) stated (at 265):

> "Without purporting to rule on the matter in any way, we can certainly visualize the possibility that a court confronted with a contention of entitlement to a market price basis higher than the producer's ceiling would consider it to run counter to the intention of the parties, unless there is something to rebut the fair presumption that they contemplated interstate movement and market prices compatible therewith. The

[10] A dispute over these items could always be framed in terms of a settlement agreement to end litigation.

> court might also consider that this result would be in furtherance of

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> the general principle against application of contracts so as to contravene public policy, whether or not the result would be in violation of supremacy clause doctrine prohibiting state rules or decisions that require a regulated company to take action inconsistent with Federal regulation, see Northern Natural Gas Co. v. State Corp. Comm. of Kansas, 372 U.S. 84, 83 S. Ct. 646, 9 L. Ed. 2d 601 (1963)."

There is nothing in the instant case to "rebut the fair presumption" that Pennzoil, Shell and Williams "contemplated interstate movement and market prices compatible therewith." On the contrary, Pennzoil and Shell entered into their first sales contracts with United (which, of course, was selling the gas in interstate commerce for resale) in the early 1940's and those contracts were periodically renewed, all with at least the knowledge and acquiescence of Williams, into the 1950's (see Ex. 4) and after the Supreme Court's decision in *Phillips Petroleum Company* v. *Wisconsin,* 347 U.S. 672 (1954) established Commission jurisdiction under the Natural Gas Act over producer sales in interstate commerce for resale. Indeed, it was in January 1955, after the *Phillips* decision, that Williams amended the 1952 lease to require royalties based on 1/4 of the market value (Ex. 10).[11]

[11] It would seem that a prime purpose of the market value lease provision is to insure that the lessee will use his best efforts to sell the gas at the highest price he legally can. This cannot exceed the Commission ceiling price when Pennzoil or Shell sell the gas involved here. Even if the leases were cancelled and the acreage reverted to Williams, the gas would still be dedicated to the interstate market and Williams would be bound not to sell at higher than the Commission ceiling (see Section IV, *infra*). It would be anomalous for the Louisiana court to hold that "market value," where neither the producer-lessee nor the lessor himself could lawfully sell the gas at more than the ceiling price, exceeds the ceiling.

Moreover, even if Williams were to prevail on the construction of "market value," it is doubtful that the Louisiana court would decree lease cancellation for underpayment of royalties. For as intervenor, Michigan Wisconsin Pipe Line

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Company, points out in its brief (Initial Brief, p. 9), recent Louisiana cases hold that a failure or delay of royalty payments is justified where there is a legitimate dispute or uncertainty as to the lessee's obligation.[12]

Furthermore, even if the leases were cancelled and the acreage reverted to Williams, the gas would still remain dedicated to the interstate market and could not be diverted therefrom without abandonment authorization granted by the Commission to Williams (see Section IV, *infra*). Failing such abandonment authorization, Williams could not sell the gas at prices in excess of the Commission-established area and nationwide rates. And, contrary to petitioners' assertion, Williams would not be authorized to sell at the small producer rate of 130% of the nationwide rate (Opinion No. 742, Aug. 20, 1975) since gas sales attributable to the leases in question exceed 10,000,000 Mcf a year (Shell's yearly sales were 1,309.4 MMcf (Ex. 10), and Pennzoil's were 25,588,412 Mcf (Tr. 48)).

The foregoing is not to be taken as expressing the view that Pennzoil and Shell would prevail if the state court case were litigated. The issues are not free from doubt and there is some risk[13] they would lose. However, it is also

[12] Pennzoil, Shell and United adduced no expert testimony as to Louisiana law, nor did they brief this matter. A good discussion of Louisiana law on the construction of market value and on lease cancellation is contained in Michigan Wisconsin's brief.

[13] Shell and Pennzoil have not attempted here to measure the risk. The most they would say is that they take the litigation "seriously" and took several months to negotiate the settlement (see, e.g., Tr. 38, 39, 41). Of course, the higher they assess the risks, the greater will be their incentive to implement the Settlement Agreement even if their petitions are denied.

clear they would have a reasonably good chance of prevailing. Special relief here should not be based on the speculative outcome of the state court litigation. And, as noted, in *Fourth, supra,* even if it were finally adjudicated by the

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state courts that the market value basis for royalty payments were 78 cents or $1.40 per Mcf, or some other figure, the same issues would be present here. Pennzoil and Shell would still have to establish on the basis of their own costs and revenues that they could not absorb the higher royalty payments without a price increase. This, Pennzoil has not even attempted to do. And Shell has failed in its attempt.

IV

PETITIONERS HAVE NOT ESTABLISHED THAT ABANDONMENT OF THE ROYALTY INTEREST IN THE GAS IS PERMITTED BY THE PUBLIC CONVENIENCE OR NECESSITY

The instant petitions request, as an alternative if special relief is not granted to flow through increased royalty costs based on 78 cents per Mcf, that the Commission authorize abandonment of one-eighth of the gas under the 1934 lease and one-fourth of the gas under the 1952 lease (i.e., the royalty interests in the leases). This request for abandonment authorization is pursuant to the Settlement Agreement of June 18, 1975 between Pennzoil, Shell and Williams, wherein Williams agreed, in lieu of higher royalty payments, to accept in settlement of the litigation deliveries in kind of the aforementioned shares of the gas "for use or sale by Lessor [Williams] to any market" (Settlement Agreement, Section I.B; Appendix A to Shell's Petition).[14]

[14] United has agreed, upon Commission authorization, to release from its gas purchase contracts with Pennzoil and Shell only ⅛ of the gas (Ex. 7, Tr. 53; Ex. 8, Tr. 56).

Petitioners have a heavy burden of proof to establish that abandonment of gas which has been dedicated to the interstate market is permitted by the public convenience or necessity. Section 7(b), Natural Gas Act,[15] 15 U.S.C., § 717 f (b);

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Michigan Consolidated Gas Company v. *F.P.C.*, 283 F.2d 204, 214 (C.A.D.C. 1960), cert. denied, 364 U.S. 913; ***Transcontinental Gas P.L. Corp.*** v. ***Federal Power Com'n***, 488 F.2d 1325 (C.A.D.C. 1973), cert. denied, 417 U.S. 921; ***Deep South Oil Company of Texas***, 25 F.P.C. 734 (1961).

Petitioners have not satisfied their rigorous burden of proof. The basis for the requested abandonment is Williams' claim to higher royalty payments and the ensuing state court litigation. Petitioners claim that because of the risks of that litigation it is in the public interest to abandon one-eighth and one-quarter of the gas to the intrastate market rather than chance losing all the gas to that market.

Williams, however, has agreed to accept higher royalty payments, computed on the basis of 78 cents per Mcf, in full settlement of its claims in the litigation. We have seen in Section III, *supra*, that Shell can absorb such higher royalty costs without an increase over the area and nationwide rates. Pennzoil did not even attempt to make any showing that it could not absorb such higher royalty costs. Since Pennzoil's costs, revenues and profits attributable to the 1934 lease are peculiarly within its knowledge and it has the burden of proof, its failure to adduce any evidence whatsoever on the issue warrants the inference that

[15] There is no issue here of depletion of reserves. As of January 1, 1975, Shell's and Pennzoil's estimated remaining recoverable reserves in the Gibson Field, of which the Williams leases acreages are a part, were 68.7 Bcf and 86.2 Bcf, respectively (Tr. 48, 58). No data were presented as to the reserves attributable to the Williams leases themselves.

Pennzoil can absorb the higher royalty costs without an increase over the area and nationwide rates. Since both Pennzoil and Shell have the ready means, within their costs and profit margins, of avoiding the risk that the state court might decree cancellation of the leases and possible diversion of the gas from the interstate market, their petitions for abandonment of the royalty owner's share of the gas must be denied.

Wholly apart from the foregoing, their abandonment petitions must be denied. They are based entirely on Williams' unadjudicated claims that it is entitled to higher royalty payments and lease cancellation for underpayment of such royalties. If unadjudicated claims, whether for higher royalties or for any of the other elements which make up the gas producers' costs of production, can serve as the basis for abandonment, then the critical gas shortage in the interstate market will be severely worsened, a result which is surely contrary to the public interest.

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We have shown (Section III, *supra*), that it is at best doubtful whether Williams would prevail in the state court litigation on the market value royalty issue. Even if Williams did prevail on that issue, it is extremely doubtful that the state court would decree cancellation of the leases. But even if such cancellation were ordered, this does not mean that the gas would be diverted from the interstate market. For under the Commission's recent ruling in *El Paso Natural Gas Company, et al.*,[16] (Opinions 737 and 737-A, issued July 11 and September 3, 1975), Williams would be bound to continue selling the gas in the interstate market (see also *Hunt Oil Co.* v. *F.P.C.* 306 F.2d 334, 342 (5th Cir., 1962).

[16] Pending on petition for review *sub nom.*, ***Southland Royalty Company*** v. *F.P.C.*, 5th Cir., No. 75-3373.

Indeed, *El Paso* is an *a fortiori* case, since, unlike the situation here, there was no question in *El Paso* that the acreage would revert to the lessor (upon expiration of the lease term).

Speculation as to the outcome of unadjudicated royalty claims, and the disire of Pennzoil and Shell to rid themselves of potential damages liability, cannot serve as the basis for meeting the stringent public interest standard of Section 7(b) for abandonment.

Moreover, as has been well stated by the Staff (Initial Brief, p. 9):

> "Nor is abandonment authorized because pending litigation to cancel the leases casts a cloud over further expenditures (Tr. 77). From a practical standpoint, this argument carries little weight, since the Louisiana court has already indicated that the parties could expect to go to trial this fall (Tr. 41). Moreover, the court in *Michigan Consolidated Gas Company* v. *F.P.C.*, 283 F.2d 204 (D.C. Cir. 1960), cert. denied, 364 U.S. 913 (1960),
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> disposed of this type of self-interest reasoning when it stated that simply because an applicant wants to abandon service 'because it wants to be rid of what it considers to be a vexatious servitude' is not a reason for granting its request (283 F.2d 204, at 214)."

V

THE REQUESTED SURCHARGE FOR PAST ROYALTIES MUST BE DENIED

The instant petitions for special relief request an increase above area and nationwide ceiling rates in order to impose a surcharge for higher royalty payments called

for in the Settlement Agreement of June 18, 1975[17] or gas sales made between January 1, 1974, and the date of a Commission order approving special relief to flow through higher royalty payments on sales made after the date of such an order. This request for a temporary surcharge for royalties on past deliveries must be denied.

In the first place, the Commission in its August 29, 1975, order has denied "[t]hose portions of the petitions relating to temporary surcharges for back royalty payments by Shell and Pennzoil" (Ordering par. (B), at p. 4). This specific surcharge denial was treated separately in the Order from the Commission's denial of the requested special relief for increased royalty payments (Ordering par. (A); see also Commission findings (1) and (2), p. 3). Pennzoil's Application For Rehearing and Reconsideration does not even mention the surcharge issue. And the Commission's order of September 22, 1975, granting the Application, merely vacated "[t]hat portion of the August 29, 1975, order denying Pennzoil's and Shell's petitions for special relief." (Ordering par. (B)).

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Thus, the Commission's August 29, 1975, denial of the requested surcharge was not vacated by its September 22, 1975, order, and the surcharge issue is now foreclosed. While Pennzoil has made a brief reference to the surcharge matter in its initial brief (p. 10), Shell has not briefed it at all.

Secondly, the petitions' requests for price increases to reflect the surcharge for past royalties tracks the June 18, 1975, Settlement Agreement of the parties. No surcharge would be due under that Agreement in the absence of Commission approval. For the higher royalties on 1974 gas

[17] See Section II B of the Settlement Agreement (Appendix A to Shell's Petition).

deliveries (which are to be computed on the basis of 45 cents per Mcf) are to be paid by Pennzoil and Shell to Williams "only to the extent the FPC permits Lessees [Pennzoil and Shell] to recover such amounts from United" (Agreement, Sec. II B(a)). Since such a recovery has been denied by the Commission, or is denied by this decision (of course, subject to Commission review), no surcharge would be payable on 1974 deliveries.

As to the surcharge for deliveries made in 1975 and prior to the date of a Commission order herein, the Settlement Agreement provides that the higher royalty payments shall be made to Williams only "(if the Commission approves Section I.A. hereof)."[18] (Agreement Sec. II.B.(b) [parenthesis is in the Agreement].) Since the parties agreed that a surcharge for royalties would be due on deliveries made in 1975 and prior to the date of the Commission's decision, only in the event the Commission grants the special relief request as to future royalties, and since such special relief must be denied for future royalties, the surcharge for past royalties would not be due under the Agreement. Moreover, Section VIII of the Agreement does not reserve to the parties an option to terminate the Agreement for failure of the Commission to approve the surcharge. Apparently in recognition of the

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foregoing, Pennzoil has candidly conceded that "implementation of the settlement is not contingent upon approval of the surcharge" (Initial Brief, p. 10).[19]

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[18] Section I.A. of the Settlement Agreement refers to the parties' agreed-upon royalty basis of 78 cents per Mcf and the flow-through of such increased royalty payments to United – treated in Section III, above.

[19] Pennzoil went on to add that nevertheless the surcharge should be approved "as a most reasonable resolution of the claim for alleged past underpayment of royalties" (p. 10).

Thirdly, no justification has been established by Pennzoil or Shell, in terms of their costs, revenues and profits attributable to operations under the Williams leases, which would warrant an increase over area or nationwide rates for imposition of the surcharge against United (see Section III, *supra*).

Finally, wholly apart from the foregoing, and even if the Commission were to approve the special relief request insofar as relating to royalties on future deliveries, the request for a surcharge for royalties on past deliveries must be denied. Petitioners are requesting an increase above area and nationwide ceiling rates in order to impose a surcharge against United for the producers' alleged underpayment of royalties on past deliveries of gas to United. The Commission in the instant proceeding has recognized that there "is no basis for allowing a temporary surcharge for the purpose of permitting a producer to recover retroactive royalty payments." (Order of August 29, 1975, finding (2), p. 3). The surcharge would be a kind of retroactive rate increase, which is forbidden by Section 4 of the Natural Gas Act (*Continental Oil* v. *F.P.C.*, 236 F.2d 839 (5th Cir., 1956), cert. denied, 352 U.S. 996; *Shell Oil Company* v. *F.P.C.*, 334 F.2d 1002 (3rd Cir., 1964)).

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VI

ULTIMATE FINDINGS AND ORDER

Upon consideration of the entire record, including the briefs filed in this proceeding, it is further found and concluded:

(1) Petitioners Pennzoil and Shell are each engaged in the sale of natural gas in interstate commerce for resale and each, is, therefore, a "natural-gas company" within the meaning of the Natural Gas Act.

(2) Pennzoil's and Shell's sales of natural gas attributable to the Williams leases, which are the subject of the petitions herein for special relief and for abandonment, as more fully described hereinabove and in the petitions herein, are made in interstate commerce for resale and are subject to the jurisdiction of the Commission.

(3) Pennzoil has failed to establish that its requested gas price increases above area (Opinion No. 598) and nationwide rates (Opinion No. 699 orders), as more fully described hereinabove and in Pennzoil's petition for special relief, are justified in the public interest, convenience and necessity or that the requested rates are just and reasonable. The aforesaid relief sought by Pennzoil is contrary to the public interest, convenience and necessity and the requested rates are not just and reasonable.

(4) Shell has failed to establish that its requested gas price increases above area (Opinion No. 598) and nationwide rates (Opinion No. 699 orders), as more fully described hereinabove and in Shell's petition for special relief, are justified in the public interest, convenience and necessity or that the requested rates are just and reasonable. The aforesaid relief sought by Shell is contrary to the public interest, convenience and necessity and the requested rates are not just and reasonable.

(5) Pennzoil has failed to establish that its requested surcharge, as more fully described hereinabove and in Pennzoil's petition for special relief, is justified in the public interest, convenience and necessity or that the requested surcharge is just and reasonable. The aforesaid relief sought by Pennzoil is contrary to the public interest, convenience and necessity and the requested surcharge is not just and reasonable and is otherwise prohibited by Section 4 of the Natural Gas Act.

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(6) Shell has failed to establish that its requested surcharge, as more fully described hereinabove and in Shell's petition for special relief, is justified in the public interest, convenience and necessity or that the requested surcharge is just and reasonable. The aforesaid relief sought by Shell is contrary to the public interest, convenience and necessity and the requested surcharge is not just and reasonable and is otherwise prohibited by Section 4 of the Natural Gas Act.

(7) Pennzoil has not established that the available supply of natural gas, which is the subject of its petition herein for abandonment, is depleted to the extent that continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment, as required by Section 7(b) of the Natural Gas Act.

(8) Shell has not established that the available supply of natural gas, which is the subject of its petition herein for abandonment, is depleted to the extent that continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment, as required by Section 7(b) of the Natural Gas Act.

WHEREFORE, IT IS ORDERED, subject to review by the Commission, on appeal or on its own motion, as provided in the Commission's Rules of Practice and Procedure, that the petitions herein of Pennzoil and Shell be, and they are hereby, denied in all respects.

Dated this 19th day of November, 1975.

SAMUEL Z. GORDON
Samuel Z. Gordon
Presiding Administrative Law Judge

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

PENNZOIL PRODUCING COMPANY

Docket No. RI76-8

SHELL OIL COMPANY

Docket No. RI76-10

BRIEF ON EXCEPTIONS

STATEMENT OF THE CASE

In this proceeding, the Commission has been asked to approve either alternative contained in a settlement agreement entered into by Pennzoil Producing Company (Pennzoil) and Shell Oil Company (Shell) with Williams, Inc. (Williams), one of their lessors, arising out of pending market value royalty litigation in a Louisiana state court. Two leases executed by Williams — one in 1934 and one in 1952 — are involved in the litigation. Shell and Pennzoil sell gas produced from the Gibson Field, Terrebonne Parish, Louisiana to United Gas Pipe Line Company (United) under their FPC Rate Schedules Nos. 202 and 234 respectively. The gas sold to United is produced from both Williams leases as well as from leases executed by other lessors.

Williams has demanded royalty payments based upon prices substantially in excess of the ceiling rates prescribed by the Commission for these sales, and has declared the leases terminated for the failure of Pennzoil and Shell to pay the amount of royalties demanded. Shell and Pennzoil have asked a Louisiana state court to issue an injunction

and declare that Shell and Pennzoil are paying the correct royalties. By reconventional demand (counterclaim) Williams has asked the Court to declare the leases terminated and to assess damages for the alleged underpayment of royalties.

As a result of extensive negotiations, Pennzoil, Shell and Williams reached a settlement agreement which, if implemented by the Commission, would resolve this litigation. Among other provisions of this settlement, Pennzoil and Shell agreed to seek Commission authorization to collect increased rates from United to reflect increased royalty payments based upon negotiated rates substantially less than the rates demanded by Williams as market value, or, in the alternative, in the event that authorization for increased rates is denied, to seek authorization to abandon the sale of the royalty portion of the gas. United, expressing its agreement with the settlement, consented to amend its gas purchase contracts to provide

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for the increased rates or to release the royalty portion of the gas, depending on the alternative approved by the Commission.

Pursuant to the settlement, Pennzoil filed in Docket No. RI76-8 and Shell filed in Docket No. RI76-10 petitions seeking Commission approval of the increased rates to reflect the higher royalty payments demanded by Williams, or alternatively, the petitions requested Commission approval to abandon the royalty interest portions of the gas. On August 29, 1975, the Commission, finding that "there is no justification for allowing a producer to pass through higher royalty costs to the consumer without a showing that Petitioner's overall costs are higher than those reflected in Opinion 699-H", (Order, p. 3) denied requests by Pennzoil and Shell for rate increases. Further,

the Commission consolidated the dockets and scheduled a hearing for September 23, 1975, on the applications to abandon the royalty portions of the gas.

The Commission, however, on September 22, 1975, issued an order granting the Application For Rehearing filed by Pennzoil and vacating that portion of the order of August 29, 1975, which denied the requests for special rate relief. Upon its own motion the Commission applied their ruling to Shell. On this date the Commission also granted interventions of various petitioners, including United.

A hearing was held on September 23, 1975, at which time Shell, Pennzoil and United adduced testimony of witnesses and presented documentary evidence. In his decision issued November 24, 1974, the Presiding Administrative Law Judge, Samuel Z. Gordon, concluded that both Pennzoil and Shell failed to establish that their requested gas price increases above the Commission's prescribed rates are justified in the public interest, convenience and necessity or that the requested rates are just and reasonable. He further concluded that the requested surcharge for past royalties is not justified in the public interest, convenience and necessity or just and reasonable and that the abandonment of the royalty portions of the gas is not permitted by the present or future public convenience and necessity.

SUMMARY OF UNITED'S BASIC POSITION

United intervened in the proceeding on the basis of letter agreements it executed with Pennzoil and Shell in which it agreed, subject to Commission approval, to give effect to the settlement agreement reached between Pennzoil, Shell and Williams. United considers the issues presented by the pending market value royalty litigation as serious ones. If Williams

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is successful in terminating the leases, United and its customers could lose all the gas United is currently purchasing from the acreage covered by the Williams leases. It therefore appeared to be in the best interests of United and its customers to execute the letter agreements with Pennzoil and Shell.

United believes that the settlement is reasonable and in the public interest and that these criteria, rather than a producer cost standard, should be utilized by the Commission in adjudging the requests of Pennzoil and Shell. United prefers the increased rate alternative because United and its customers would retain all the gas from the acreage covered by the Williams' leases at only slightly higher prices. This assumes, of course, United's right to reflect the increased prices in its jurisdictional rates. However, if the Commission denies this alternative, United prefers the abandonment of the royalty portion of the gas rather than face the uncertain outcome of the state court litigation and its possible adverse results.

EXCEPTIONS

Point I. The Presiding Judge erred in holding that the price increases contained in the settlement agreement are not justified in the public interest, convenience and necessity and are not just and reasonable.

Point II. The Presiding Judge erred in holding that the present or future public convenience and necessity does not permit approval of the abandonment of that portion of the gas attributable to the royalty owner's interests.

ARGUMENT IN SUPPORT OF EXCEPTIONS

The Commission is cognizant of the problems presented by market value royalty claims which could result in the

payment of royalties based upon some rate other than those prescribed by the Commission. In response to *Texas Oil & Gas* v. *Vela,* 429 S.W.2d 866 (Tex. 1968), and *J. M. Huber Corp.* v. *Denman,* 367 F.2d 104 (5th Cir. 1966), the Commission, attempting to control the maximum amount to be paid royalty owners under jurisdictional sales, held in Opinion 562, issued July 32, 1969, that it had jurisdiction over royalty interest owners. The Commission's determination was subsequently reversed in *Mobil Oil Corporation* v. *FPC,* 462 F.2d 256 (D.C. Cir. 1972), *cert. denied,* 406 U.S. 976 (1972). The Court held that the royalty provision of a lease does not constitute a sale of gas for resale and thus the amount a royalty owner receives for his royalty share of gas sold in interstate commerce is not subject to the jurisdiction of the Commission.

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Recently the problem has grown more acute because of the growing disparity between prices applicable to intrastate contracts and Commission prescribed rates applicable to interstate contracts. This proceeding is not an isolated case before the Commission. There are currently several related market value royalty proceedings pending before the Commission. (e.g. *Roy M. Huffington, Inc.,* Docket No. CI75-602, *Exxon Corp.,* Docket No. RI76-29). The Commission must attempt to resolve the issues presented by market value royalty claims to insure a solution which will be in the public interest, by maintaining the continuous supply of gas to the interstate market at reasonable prices. In this proceeding the parties have settled their litigation after extensive negotiation. This settlement is now before the Commission for approval. It offers a reasonable, certain and practical resolution of complex issues and should be approved in the public interest.

POINT I

The Presiding Judge erred in holding that the price increases contained in the settlement agreement are not justified in the public interest, convenience and necessity and are not just and reasonable.

The Presiding Judge held that the increased rates provided for in the settlement must be denied because Pennzoil and Shell had not proved ". . . that their overall costs with the increased royalty payments will be greater than the ceiling rates or that their out-of-pocket expenditures will exceed revenues." (Initial Decision, p. 15) Whether Pennzoil and Shell have or have not made such a showing is beside the point. The public interest cannot be so narrow or limited as the cost experience of an individual producer or an individual project. The public interest is concerned with certainty of gas supply and maintaining the continuous supply to the interstate market at reasonable prices. The settlement before the Commission must be assessed in terms of its reasonableness and the public interest in that it removes the risks and unpredictability associated with the pending litigation. The settlement would remove these risks at a slightly higher price to the consumer which is justified in light of the advantages to be gained.

The increase rate alternative of the settlement agreement is in the public interest because it will provide:

1. *Certainty* of gas supply. If the increased rate alternative of the settlement is approved by the Commission, the state court litigation will be resolved, and the risk that the leases could be terminated and the gas lost to United and the interstate market would be eliminated. It is unreasonable to rely on Opinion No. 737 (in which the

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Commission indicated that gas once dedicated to the interstate market remains dedicated after lease termination) as negating this risk altogether. Opinion No. 737 is currently on appeal, *sub. nom., Southland Royalty Co.* v. *FPC* (5th Cir. 75-2851), and its outcome is uncertain. In view of the uncertainty surrounding the outcome of the litigation, the only way to insure the retention of all the gas produced from the acreage covered by the Williams leases is to grant the requests for rate increases. The risk of lease termination and possible diversion of all of the gas from interstate commerce is unacceptable to United. As United's witness, D. L. Smith, Senior Vice President-Gas Supply, testified, "United is in deep curtailment and cannot stand to lose one foot of gas." (Tr. 62).

2. *Additional Supply.* If the settlement is approved Pennzoil and Shell can go forward with the work they have projected for the Williams leases to bring forth additional supply. Pennzoil's witness testified that the uncertainty of the litigation would cause Pennzoil to defer indefinitely plans for a development well and a workover of an existing well, both of which would add additional supply. (Tr. 30). Shell's witness testified that the lessor's demands had caused Shell to postpone drilling a well that had been planned. (Tr. 78-79).

3. *Reasonableness of price.* The 78 cent settlement price* upon which the increased royalty is to be computed is reasonable and is less than the record evidence of contract prices for non-jurisdictional gas purchases in Southern

* The present effective rates will not be increased to 78 cents. They will be increased only by the difference between royalty computed on a rate of 78 cents and royalty computed on the present effective rates. This difference will not accrue to the benefit of Pennzoil and Shell but will be flowed through to Williams.

Louisiana. United's witness listed ten such contracts United has with various producers under which the prices ranged from \$1.08 — \$1.58. (Tr. 64). Further, the consumer would pay less for this gas under the increased rate alternative than if the case were litigated, the leases terminated, and Williams continued to sell the gas to United. The Presiding Judge is incorrect in asserting that Williams would not be authorized to collect the small producer rate. (Initial Decision, p. 22). The Presiding Judge made this assertion under the apparent belief that Williams' volumes would be in excess of 10,000,000 Mcf per year. However, the volumes attributed to Pennzoil's sales cited by the Presiding Judge are field-wide volumes of which the volumes produced from the Williams leases are only a part. Further, even if Williams were in excess of 10,000,000 Mcf, Williams would be

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entitled to collect the small producer rate for the first 10,000,000 Mcf sold subsequent to lease termination, as Williams is currently making no jurisdictional sales. Section 157.40 of the Commission's Rules and Regulations. The small producer rate pursuant to Opinion No. 742 would be 130% of the national rate for new gas which would be 68 cents, not including adjustments. This is a substantially higher rate than those requested by Pennzoil and Shell in this proceeding.

POINT II

The Presiding Judge erred in holding that the present or future public convenience and necessity does not permit approval of the abandonment requests.

Section 7(b) of the Natural Gas Act provides that abandonment is appropriate if permitted by the public convenience and necessity. United does not disagree with the

Presiding Judge's statement that, "Petitioners have a heavy burden of proof to establish that abandonment of gas which has been dedicated to the interstate market is permitted by the public convenience and necessity." (Initial Decision, p. 23). The natural gas shortage which presently faces the nation requires that all efforts be made to maintain and secure gas supplies for the interstate market for the benefit of gas consumers.

United clearly prefers Commission approval of the requests for increased rates to reflect the increase in royalties. However, if this alternative is denied, and United is faced with the risk of lease termination and the possible loss of all the gas produced from the Williams leases, Commission approval of the requests to abandon the royalty portions of the gas would insure that United and its customers retain the major portion of the gas that which is attributable to the working interests. Elimination of this risk has to be consistent with the public convenience and necessity.

CONCLUSION

Approval of the increased royalty alternative of the settlement agreement is in the public interest. It will not only assure that the production from the Williams leases will continue to be committed to United and the interstate market, but it will also enable Pennzoil and Shell to proceed with their development plans for these leases. Further, these two advantages will be made available to the consumer at rates

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only slightly higher than are currently being paid. The settlement before the Commission for approval is a reasonable one, and represents an effort to resolve the market

value royalty issue in a manner consistent with the best interests of the parties, United and its customers.

Respectfully submitted,

William B. Cassin
Group Vice President and
General Counsel

Phillip D. Endom
Vice President and
Associate General
Counsel

W. O. Crain, Jr.
Lee M. Huber
700 Milam, P. O. Box 1478
Houston, Texas 77001

Donald R. Arnett
1223 Chamber of
Commerce Bldg.
Houston, Texas 77002

By LEE M. HUBER
Lee M. Huber

Attorneys for United Gas
Pipe Line Company

December 19, 1975
Houston, Texas

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UNITED STATES OF AMERICA
BEFORE THE
FEDERAL POWER COMMISSION

PENNZOIL PRODUCING COMPANY
Docket No. RI76-8
SHELL OIL COMPANY
Docket No. RI76-10

Brief on Exceptions of
Pennzoil Producing Company

Pennzoil Producing Company, pursuant to Section 1.31 of the Commission's Rules of Practice and Procedure, respectfully submits herewith its Brief on Exceptions to the Initial Decision of the Administrative Law Judge, issued in this proceeding on November 24, 1975.

I.
STATEMENT OF THE CASE

This proceeding involves a settlement of a complex case and is a direct result of litigation in a Louisiana state court in which Williams Inc. (Williams) has asserted market value royalty claims against Pennzoil Producing Company (Producing) and Shell Oil Company (Shell).[1] While the parties have reached an agreement which will settle the litigation, implementation of that settlement is dependent upon affirmative Commission action in this proceeding. Without question, the resolution of the litigation, whether by way of settlement or by way of trial, will have a substantial impact on gas consumers. Thus, since this Commission is charged with protecting the interests of gas consumers, it is incumbent upon the Commission to insure that

[1] *Shell Oil Company and Pennzoil Producing Company* v. *Williams Inc., et al.,* Civil District Court for Orleans Parish, Louisiana, Docket No. 573-591.

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the litigation is resolved in the manner most consistent with those interests. Consequently, the ultimate issue that must be resolved in this case is whether it is in the best interest of interstate gas consumers to allow settlement of the state court litigation.

The litigation involves gas sold by Producing in interstate commerce from the Gibson Field, Terrebonne Parish, Louisiana. The Gibson Field acreage is covered by a 1934 lease from Williams to Shell Oil Company. Producing obtained its interest in the acreage as a result of a 1942 sublease from Shell. The royalty which Producing (lessee) must pay to Williams (lessor) is governed by section 4 of the 1934 lease, which provides in pertinent part as follows:

> "Lessee agrees as to royalties: . . . to pay Lessor for gas/or casinghead gas . . . one-eighth ($\frac{1}{8}$) of the value thereof, calculated at the market rate prevailing at the well . . . ." (Exhibit 9, at 3.)

Producing is selling the gas covered by the 1934 lease to United Gas Pipe Line Company (United) in interstate commerce for resale under Producing's Rate Schedule No. 234. Thus, under Section 1(b) of the Natural Gas Act the price Producing may collect from United is subject to the jurisdiction of the Commission, and the Commission has established maximum rates which are applicable to this sale. A portion of the gas is covered by Opinion No. 598 (Southern Louisiana Area Rate) and the rest is covered by Opinion No. 699-H (national rate for new gas). Producing is collecting the highest just and reasonable price allowed under these opinions. (Tr. 24) Producing is paying royalty to Williams based on these prices, *i.e.,* for old gas one-eighth of the Opinion No. 598 rate and for new gas one-eighth of the Opinion 699-H rate.

Williams, however, claims that the "market rate" for the gas is in excess of that which the Commission has determined to be the highest just and reasonable rate which Producing may collect. Williams therefore demanded payment of royalties based on such higher rates and declared the lease terminated for Producing's alleged failure to pay royalty based on the prices Williams claimed to be the "market rate." (Tr. 24; Exhibits 1-3) Litigation has resulted in which Producing has asked a Louisiana State Court to issue an injunction preventing lease termination and declare that Producing is paying the correct royalty. Williams has asked the Court to declare the lease terminated as of June 5, 1974, and to assess damages (1) in excess of $3,000,000 for alleged underpayment of royalties through

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April 30, 1975, plus (2) an amount equal to the value of all minerals produced since June 5, 1974, plus (3) other damages and attorneys' fees. Williams' claim as to the "market value" upon which the royalty allegedly should be paid has escalated steadily from 70¢ per Mcf for the period November, 1973, through May, 1974, to $1.40 per Mcf for the period January, 1975, through April, 1975. (Tr. 24-25; Exhibits 4-6)

As a result of intensive negotiations, Producing and Williams have reached a settlement which, if implemented, will resolve the litigation and remove all of the uncertainties as to the status of the lease and the amount of the royalties thereunder. Implementation, however, is contingent upon Commission approval of either of two alternatives in Producing's application in this docket. The first alternative involves a rate increase, all of which would flow through to Williams in the form of increased royalties based on the higher of 78¢ (plus 1.5¢ per Mcf annual escalations beginning January 1, 1976) or 150% of the highest

national or area rate permitted. The second alternative involves abandonment by Producing of the sale of the royalty share of the gas (1/8) so that Williams may take that royalty share in kind for use or sale by Williams to any market. Under this alternative, Producing will continue to sell the remaining seven-eights of the gas to United at the prices currently in effect.[2]

The settlement also provides that Williams' claim for past underpayment of royalties for the period October 1, 1971 through 1973 will be dropped. Thus payment for increased past royalties would be limited to the period January 1, 1974 through June 30, 1975, and the royalty amount would be based on 45¢ per Mcf for volumes delivered in 1974 and 85¢ per Mcf, including the 7¢ per Mcf Louisiana severance tax, for deliveries during the first six months of 1975. A surcharge would be added for twelve months to the price Producing receives from United in an amount sufficient to make up the difference between this increased royalty obligation and the amount already paid. Again this entire amount would flow through to Williams so that Producing would retain none of the increase. At the end of twelve months the surcharge would terminate and the price would decrease accordingly. Implementation of the settlement is not dependent upon Commission approval of the surcharge request.

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Pursuant to the settlement agreement, Producing filed its application for individualized rate relief in the form of the excess market value royalty flow through or, in the alternative, abandonment, on July 1, 1975. The Commission initially set the abandonment alternative of the appli-

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[2] The price would, of course, change in accordance with Commission rules and regulations and the terms of Producing's contract with United, just as it would absent the Williams litigation.

cation for hearing, but rejected the individualized rate relief alternative on the ground that a showing of overall costs in excess of those reflected in Opinion 699-H was required. (Order issued Aug. 29, 1975). On rehearing, however, the Commission reversed the prior summary rejection of the individualized rate relief application, and set that request for hearing along with the alternative abandonment proposal. (Order issued Sept. 22, 1975).

The hearing was held on September 23, 1975. In the initial decision issued on November 24, 1975, the Administrative Law Judge denied the relief Producing seeks in this proceeding.

II.

PRODUCING'S POSITION

The starting point for evaluating Producing's price increase request is that the prices Producing was collecting for gas sold from the Williams acreage were just and reasonable prior to Williams' market value royalty demands. No one has disputed this, and indeed no one can since those prices were the applicable ceiling prices that the Commission has already deemed to be just and reasonable. Also indisputable is that both the courts and the Commission have recognized that increases above the applicable ceiling rates are sometimes just and reasonable. Thus the questions to be resolved are (1) whether a price increase is justified under the circumstances of this case and, if so, (2) whether the increase Producing proposes is just and reasonable.

Two fundamental principles have been established for determining whether a price increase above the ceiling rate is appropriate. First, the ceiling price is inappropriate if out of pocket expenses exceed revenues, and therefore an increase is justified under such circumstances. Second, if

the ceiling price is *otherwise* inappropriate an increase is also justified.

Producing does not here claim that the ceiling prices are inappropriate because out of pocket expenses exceed revenues and, quite naturally, Producing has not attempted to establish what it does not claim. Producing does assert, however, that the unique circumstances of this

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case establish that the current ceiling price is otherwise inappropriate. Basically, the price is inappropriate because continuation of that price creates unacceptable risks to gas consumers, while the price increase removes those risks entirely.

The question, then, becomes whether the particular increase which Producing proposes in order to accomplish this objective is just and reasonable. On this question, two considerations are controlling. First, the price increase must not excessively increase Producing's profits since, under the current state of the law, even if the price increase is in the best interest of consumers it may nonetheless be unreasonable if it creates "excessive" profits. Second, the price increase must be a reasonable cost to be borne by consumers in order to avoid the risks associated with the current price. Stated differently, considering all of the circumstances of the litigation, the question is whether the settlement agreement is a reasonable resolution of the litigation from the point of view of gas consumers.

The evidence establishes that a price increase is essential in order to avoid the risks to gas consumers associated with the litigation. The evidence also establishes that the increase proposed by Producing will not create one cent of profit for Producing and that the unacceptable risks of the litigation will be avoided at minimal cost. Under these

circumstances the public interest demands that the price increase and surcharge be approved. In the alternative, the public interest requires that the abandonment application be approved.

III.
THE JUDGE ERRED IN REFUSING TO ADOPT THE SETTLEMENT AND DENYING THE REQUESTED RELIEF

A. The Judge Erred in Determining That Project Cost Evidence Is Required to Establish The Propriety Of The Individualized Rate Relief Request.

B. The Judge Erred In Determining That Producing's Evidence Is Not Sufficient To Establish The Need For Individualized Relief.

C. The Judge Erred In Determining That Producing's Evidence Is Not Sufficient To Establish The Need For Abandonment.

D. The Judge Erred In Denying The Surcharge Request.

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IV.
ARGUMENT

A. The Judge Erred In Determining That Project Cost Evidence Is Required To Establish The Propriety Of The Individualized Rate Relief.

All of the reasons set forth by the Judge in rejecting the individualized rate relief portion of Producing's application are dependent upon a single basic premise. The Judge's basic premise was that, no matter what the circumstances, a price increase in excess of the applicable ceiling price can only be justified by project cost evidence. Since Producing did not present project cost evidence, the Judge concluded

that Producing's price increase request must necessarily be rejected, regardless of whether compelling public interest considerations would otherwise justify the increase. If in fact such a result is required, it would indeed be an anomalous one. Examination of the authorities upon which the Judge relied, however, reveals that the Judge's basic premise was erroneous and therefore his conclusion was also in error.

First, the Judge relied on the Commission's discussion in Opinion No. 699 dealing with special relief from the national rate. Initial Decision at 11-12. To be sure, that opinion does establish that special relief will be granted when a producer can demonstrate that out-of-pocket expenses exceed revenues from sale at the national rate or when a producer can meet the requirements of Order Nos. 455, 481, or 482. But Opinion No. 699 does not establish that those are the only circumstances under which special relief is appropriate. To the contrary, the Commission specifically stated that it was not "... attempting to enumerate all circumstances which would form an adequate basis for granting special relief. . . ." *Id.* at 105. This approach to special relief, *i.e.*, an express recognition that there might be circumstances other than costs in excess of ceiling prices that will justify rate relief in excess of ceiling prices, had its genesis in the very first area rate opinion, *Permian Basin Area Rate Proceeding* 34 FPC 225-6 (1965), *aff'd* 390 U.S. 747 (1968) and has been carried through in every area or national rate decision since. *See MacDonald* v. *FPC,* 505 F.2d 355, 358 (D.C. Cir. 1974).

Likewise, neither the Supreme Court's consideration of the market value royalty problem in the context of reviewing the Southern Louisiana Area Rate Order[3] nor the Fifth

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[3] Opinion No. 598.

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Circuit discussion of the same problem in the same context supports the Judge's conclusion.[4] In *Placid Oil Company* v. *FPC,* 483 F.2d 880, 911 (5th Cir. 1973), the Court recognized the potential problem that market value royalties created, and stated that a producer faced with such a problem is entitled to seek individualized relief. As the Commission had done in Opinion No. 699 with respect to special relief in general, the court did not purport to enumerate all of the circumstances under which the individualized relief would be appropriate. Rather, the Court pointed out that relief would be available whenever market value royalty costs rendered the Opinion 598 rates "confiscatory or *otherwise inappropriate.*" *Id.* at 911. (Emphasis added).

In affirming the Fifth Circuit's opinion, the Supreme Court likewise recognized the potential market value royalty problems. The Court did not even address the circumstances under which relief from such problems would be appropriate. What the Court did do, however, was hold that ". . . an affected producer is entitled to seek individualized relief." *Mobil Oil Corp.* v. *FPC,* 417 U.S. 283, 328 (1974).

Thus, far from supporting the Judge's basic premise that special relief must necessarily always be supported by project costs, the cases upon which the Judge relied for that determination establish the antithesis of that position. First, in discussing special relief generally the Commission has repeatedly recognized that it was not foreclosing special relief based on circumstances other than those enumerated. Furthermore, the courts have held that market value royalty costs in particular can be a basis for individualized relief, not only when they render ceiling prices con-

[4] Discussed in the Initial Decision at 14.

fiscatory, but also under any other circumstances which cause the ceiling price to be inappropriate. Individualizd relief from ceiling prices which are not confiscatory but are "otherwise inappropriate" is precisely what Producing seeks in this case.

Nor are cases such as *Consumers Union of United States* v. *FPC,*[5] and *MacDonald* v. *FPC,*[6] which establish the need for cost data to support Commission approved rates, in any way inconsistent with Producing's position. Producing does not contend that the proposed price increase in this case can be supported without cost evidence. To the contrary, Producing has introduced cost evidence[6a] (Exhibit 13). Thus the issue is not whether cost evidence is required, but rather the type of cost evidence that is required. And in resolving that issue, the controlling consideration is the purpose which cost evidence serves. If Producing's cost evidence satisfies that purpose, then most certainly it is sufficient.

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The *MacDonald* case and *Cities of Fulton* v. *FPC,* 512 F.2d 947 (D.C. Cir. 1975) are especially instructive on this point. In *MacDonald,* the Commission had approved a settlement which provided for special relief in return for an increased drilling commitment on the producer's part. While the Court reversed this decision on the basis that there was inadequate cost evidence, the Court went to great lengths to point out the function of cost evidence in order to establish the reason that the cost evidence was inadequate in that case. The Court pointed out that protection of the consumer from *profiteering* was the primary purpose of the Natural Gas Act.[7] As a result, the Court found

[5] 510 F.2d 656 (D.C. Cir. 1974).
[6] 505 F.2d 355 (D.C. Cir.).
[6a] Discussed *infra* at 19-20.
[7] 505 F.2d 363.

that cost evidence must be sufficient to allow determination of the justness and reasonableness of the "new profit expectations resulting from the special relief."[8] Quoting from *City of Chicago* v. *FPC,* 458 F.2d 731, 751 (D.C. Cir. 1971), *cert. denied* 405 U.S. 1074 (1972), the Court concluded that:

> " '[W]hen the inquiry is whether a given rate is just and reasonable to the consumer, the underlying concern is whether it is *low* enough so that exploitation by the producer is prevented.' " ***MacDonald*** v. *FPC, supra* at 364. (emphasis in original).

The function of cost evidence was again examined in *Cities of Fulton* v. *FPC, supra.* In that case the Commission had approved an application under which a producing subsidiary of a pipeline proposed to sell to the pipeline at area rates gas produced from leases acquired by the pipeline prior to October 7, 1969 and subsequently transferred to the subsidiary.[9] The Commission had traditionally priced such pipeline production on a cost of service rather than an area rate basis.[10] However, the Commission allowed the higher area rate basis in that case because the producing subsidiary agreed to plow back into exploration and development the difference between the revenue received under area rate treatment and that which would have been received under cost of service treatment.

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In reviewing the Commission's approval of area rate treatment, the *Cities of Fulton* Court was first concerned with whether the cost evidence was sufficient. As in *MacDonald,* the Court considered the function of cost evidence in order to make this determination. The Court observed

[8] 505 F.2d 365.

[9] *Panhandle Eastern Pipe Line Company, et al,* Docket No. CP71-237,*et al,* Opinion Nos. 626 and 626-A (1972).

[10] ***Pipeline Production Area Rate Proceeding,*** **Docket No. RP66-24 (Phase II) (Order Issued June 14, 1972).**

that the cost evidence in *MacDonald* had been deemed insufficient because it did not establish that the special relief price would not yield 'excessive profit returns'."[11] Evaluating the cost evidence on that basis, the Court concluded that is was sufficient since it established (1) the amount of the increased profits so as to allow a determination that they were not excessive and (2) that under the unique circumstances of that case the benefits to gas consumers justified a price (area rates) in excess of what otherwise would have been appropriate (cost of service).

The need to tailor the cost evidence requirement to the purpose served by such evidence has also recently been expressly recognized by the Commission in *American Petrofina Company of Texas (Operator) et al.,* Docket Nos. RI75-17 and RI75-19 (Order Issued March 3, 1975). In that case, the producer sought an increase above the applicable ceiling rate that was being collected in order to cover the costs of additional compression. As in all price increase cases, the Commission was concerned with the sufficiency of the cost evidence. But the Commission did not assess the sufficiency of that evidence with blinders on. Rather, the Commission considered the unique circumstances of the case in making that assessment. In so doing the Commission determined that an assessment of the propriety of a price increase above the applicable ceiling price designed to reflect exact and measurable incremental costs does not require an inquiry into overall costs:

> "Because American Petrofina is currently charging the applicable area ceiling rate, its rate is just and reasonable *without inquiry into its actual total costs of production.* An increase in a just and reasonable rate to reflect the *exact incremental cost per Mcf* of compression expenses should not, of itself, deprive that rate of its just and reasonable character." *Id.* at 4. (Emphasis added).

[11] ***Cities of Fulton, supra*** **at 365.**

The cost inquiry was therefore limited to the costs and revenues associated with the price increase. On that basis, the Commission concluded that the price increase was justified because it would not increase the producer's profits and

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because it was a reasonable price to pay for the benefits achieved.[12]

In sum, while it is clear that cost evidence is required in this case, it is equally clear that project cost evidence or evidence establishing that the current price is confiscatory is not required. Rather, the evidence must establish first that, for whatever reason, the current price is inappropriate. In addition, the evidence must establish that the price increase which Producing proposes (1) does not excessively increase Producing's profits and (2) is a reasonable price for consumers to pay in order to eliminate the circumstances which render the current price inappropriate. On all counts, the evidence presented by Producing in this case establishes that the increase is just and reasonable.

B. The Judge Erred In Concluding That The Evidence Does Not Establish That The Rate Increase Is Just And Reasonable.

The Judge's erroneous determination that project cost type evidence is a prerequisite to the individualized relief Producing seeks precluded consideration of the sufficiency

[12] For similar Commission action see Barnwell, Inc., Docket No. CI72-654 (issued August 2, 1973); Petro-Lewis Corp., Docket No. RI74-43 (issued January 10, 1974); Texas Pacific Oil Co., Inc., Docket No. RI74-49 (issued January 10, 1974); Mapco Inc., Docket No. RI74-129 (issued February 7, 1974); T. L. Nutt, Docket No. RI74-78 (issued March 18, 1974); Suburban Propane Corp., Docket No. RI74-111 (issued April 4, 1974); KWB Oil Property Management, Inc., Docket No. RI74-194 (issued April 7, 1975); HNG Oil Co., (Operator) *et al.*, Docket No. RI75-7, (issued April 22, 1975).

of the evidence based on the proper standard. As a result, even though the Judge recognized that the arguments set forth by Producing and Shell as to the propriety of the settlement agreement "have certain attractions,"[13] the Judge nonetheless felt constrained to reject the rate increase application. The evidence reveals that Producing's application does indeed have certain attractions, and when that evidence is measured by the appropriate standard the propriety of the rate increase is clear.

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1. The Risks Of The Williams Litigation To Gas Consumers Render The Current Price Inappropriate.

The price Producing is currently collecting for gas sold from the Williams acreage is currently inappropriate for one reason and one reason only. Williams' market value royalty claims create significant and unacceptable risks to gas consumers. If the price is increased, those risks will be eliminated by way of settlement of the litigation.

The risks are present because both of the legal issues which underlie Producing's application in this case are unresolved. The first unresolved issue is the outcome of the Williams litigation. The second unresolved issue involves the impact that an adverse resolution will have on gas consumers.

a. The risks of the litigation.

In discussing the risks associated with Williams' market value royalty claims, Producing certainly does not intend to establish that Williams' position will ultimately prevail if the matter is litigated. Indeed, Producing's position in the lawsuit is that Producing has been and is paying the

[13] Initial Decision at 10.

proper royalty and that lease termination is inappropriate. But for purposes of this proceeding, the critical fact is that the outcome of the litigation is unpredictable.

The market value royalty problem had its genesis in cases such as *Texas Oil and Gas* v. *Vela,* 429 S.W.2d 866 (Tex. 1966) and *J. M. Huber Corp.* v. *Denman,* 367 F.2d 104 (5th Cir. 1966). In those cases, the courts determined the market value royalty provisions there involved did not contemplate that the royalty would be based on the price actually received by the producer-lessee for the sale of gas produced from the acreage covered by the lease, nor even that the royalty was to be based on the market value for gas produced from the leased acreage at the time the contract under which the gas was being sold was entered. Rather, the courts determined that the royalty was to be based on the market value for the gas at the time the gas is delivered. Thus, for cases covered by the *Vela-Huber* rule, the royalty basis constantly fluctuates as the market value of gas fluctuates.

While this result certainly created an unfavorable situation for some lessee-producers, standing alone it does

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not create the substantial problems under the Natural Gas Act which underlie Producing's application in this case. Such problems are generated by the combination of the *Vela-Huber* rule with the decision in *Mobil Oil Corp.* v. *FPC,* 463 F.2d 256 (D.C. Cir. 1971), *cert. denied* 406 U.S. 976 (1972). There, the court held that the royalty provision of a lease does not constitute a sale of gas for resale and thus the amount a royalty owner receives for his royalty share of gas sold in interstate commerce is not subject to the jurisdiction of the Commission. Lessors such as Williams contend that since they are not subject to the juris-

diction of the Commission, the "market value" upon which their royalty is based is not limited by the Commission's ceiling prices. While Producing believes that considerations other than those resolved in *Mobil* require a determination that the market value of gas sold in interstate commerce can not exceed applicable ceiling rates, the critical fact is that a genuine dispute as to this issue exists. And as the disparity between FPC ceiling rates and unregulated intrastate rates continues to grow, Williams' claims for increased royalties also increase.

Moreover, the problem is further exacerbated in Louisiana. For in Louisiana underpayment of royalties may be a basis for lease termination. Again, whether that result would ultimately obtain in the Williams' litigation is quite obviously unknowable at this time, and is in fact totally irrelevant. What is relevant is that lease termination is a serious possibility.

In discussing the possibility of an adverse resolution of the litigation, the Judge expressed his view that Producing and Shell will prevail. Producing certainly shares his view. But the Judge presented only one side of the argument. In so doing, the Judge relied heavily on the brief of intervenor Michigan Wisconsin Pipeline Company. Yet the Judge failed to note that, despite its exposition of the law favoring Producing's position in the litigation, Michigan Wisconsin *does not* oppose Producing's application as a reasonable basis upon which to resolve the litigation.[14]

Michigan-Wisconsin's lack of opposition to the settlement must, of course, be based on its recognition that there are, in fact, two sides to this issue. Producing has not and does not intend to present the lessor's view of the issue, for determining which side will prevail is not a part of this case. Suffice it to say that at least one

[14] Michigan-Wisconsin Initial Brief at 1, 4, 12.

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jurisdictional natural gas company is in fact making "market value" payments pursuant to a settlement agreement,[15] and that others view the problem as serious enough to warrant the institution of proceedings before this Commission.[16] It is therefore not surprising that the Judge, despite his assessment of the merits of the litigation, concluded that the issue is not free from doubt and that some risk of an adverse resolution is present. Nor is it surprising that Producing and its purchaser, United, have independently concluded that the litigation is a serious matter. (Tr. 39, 48). And it is this risk of an adverse resolution, not a subjective determination as to the ultimate outcome of the litigation, which is critical to this case.

b. **The risks of an adverse resolution of the litigation.**

The risk of adverse resolution is therefore a real one and it carries with it obvious ominous implications for interstate gas consumers. If Williams were to prevail and the lease were terminated, Williams would then have total control, to the exclusion of Producing, of the gas produced from the acreage now covered by the lease. Whether Williams could then sell in the intrastate market the gas which Producing is currently selling interstate is an open question. In the *Southland Royalty* case[17] the Commission indicated that gas dedicated to the interstate market remains dedicated after lease termination. But that determination is being vigorously contested on appeal,[18] and the ultimate

[15] El Paso Natural Gas Company, Docket No. RP74-22, *et al.* (Order Issued Nov. 29, 1974), *reh'g denied* (Jan. 29, 1975).

[16] Roy M. Huffington, Docket No. CI75-602; Exxon Corp., Docket No. CI75-602.

[17] *El Paso Natural Gas Company,* Opinion No. 737, Docket No. CP75-209 (July 11, 1975), *reh'g denied,* Opinion No. 737-A (September 3, 1975).

[18] Appeal pending *sub nom., Southland Royalty Co.* v. *FPC* (5th Cir. 75-2851).

appellate resolution is necessarily uncertain. In fact, in reaching its conclusion on this question the Commission found it necessary to overrule prior Commission precedent bearing on

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the issue,[19] a clear indication that the question is indeed a close one. Thus, without question, the possibility of termination of the Williams lease carries with it a substantial risk that the gas Producing currently sells to the interstate market will be diverted to the intrastate market. This risk is totally unacceptable during this time of critical interstate gas shortage, and it is one that United is not willing to bear or subject its customers to. (Tr. 48-49)

Moreover, even if the *Southland Royalty* case is ultimately affirmed and Williams cannot divert the gas to the intrastate market, risk of substantial adverse impact on natural gas consumers would still be associated with lease termination. The risk under these circumstances would be the distinct possibility of a substantial price increase for the gas sold from the Williams lease acreage. Producing is currently selling some of the gas at Opinion No. 598 rates and some at Opinion No. 699-H rates, with an average price per Mcf of about 40.91 cents, exclusive of Btu adjustment and tax reimbursement.[20] If the lease were terminated and the gas sales contract between United and Producing therefore also terminated, Williams would presumably be able to sell all of the gas to United as a small pro-

[19] In *El Paso* v. *Bass,* Opinion No. 638, 48 FPC 1269 (1972), the Commission held that one who holds an overriding royalty with an option to "back in" to a working interest at pay out may, upon exercise of the option and without obtaining abandonment authorization, sell the gas attributable to the working interest to a purchaser other than the purchaser who had previously purchased all of the gas. The *Bass* case was overruled in Opinion No. 737-A, at 3.

[20] Late-filed Exhibit 13 at 2.

ducer under a replacement contract at 130% of the national rate for new gas. See Federal Power Commission Rules and Regulations, Section 2.56(a)(2)(iii); Opinion No. 742, Docket No. R-393 (August 28, 1975). The price per Mcf then would be 68 cents not including adjustments (130% of 52 cents), about 27 cents per Mcf more than Producing is currently collecting.

The Judge dismissed this risk by concluding Williams would not qualify as a small producer because the sales attributable to the Williams acreage exceed 10,000,000 Mcf per year.[21] In determining whether a producer qualifies

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as a small producer, however, the test is not the amount of gas the producer will sell in the future. The test is the amount the producer sold in the year preceding the application. Commission Rules and Regulations Section 157.40(b)(1)(i). Since Williams is currently making no jurisdictional sales, Williams would qualify for a small producer certificate. Furthermore, when a small producer exceeds the 10,000,000 Mcf limit after obtaining a small producer certificate, sales made under contracts executed prior to the reporting date for the year in which the 10,000,000 Mcf limit was exceeded still qualify for small producer treatment. Commission Rules and Regulations Section 157.40(d); *E. G. Rodman,* Docket No. CS66-50 (Order issued Aug. 27, 1974). Therefore, even if the gas sold by Williams during the first year exceeded 10,000,000 Mcf, and Williams' small producer certificate were subsequently terminated as of the reporting date for that year, Williams would still receive the small producer price for those sales since they would be made under contracts executed prior to the termination date. Hence, if the lease were terminated but the gas remained dedicated to the

[21] Initial Decision at 22.

interstate market, the price would increase about 27 cents per Mcf above Producing's current average price for the same gas.

Furthermore, the risks to gas consumers of an adverse resolution of the market value issue even if not accompanied by lease termination are substantial. If Producing were forced to pay royalties on the basis of $1.40, and allowed to pass this cost on, the increase per Mcf would be about 12.5 cents.[22] Whether this cost could be passed on would be dependent upon a determination of the proper treatment of market value royalty costs.

As with the other issues in this case which create the risks the settlement is designed to eliminate, an academic resolution of this issue is not a part of this case. Rather, the critical fact is that the issue exists and creates the possibility that the price will increase substantially more if the settlement is not implemented than if it is. Yet the Judge dismissed this risk by concluding that the issue has already been resolved and that market value royalty costs can only be passed on when they render the ceiling price confiscatory.[23]

In fact no such determination has been made. A number of proceedings currently before the Commission reveal that the proper treatment of market value royalty costs is a

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very live issue and is a far reaching and complex question involving considerations far different than those pertinent to special relief based on cost factors other than market value royalty costs.

[22] The current royalty cost is one-eighth of about 40.9¢ or about 5 cents. The one-eighth royalty based on $1.40 would be about 17.5 cents.

[23] Initial Decision at 23.

The extent of the problem is illustrated by the variety of contexts in which it has recently been raised before the Commission. In addition to this proceeding, the case of *Roy M. Huffington*, Docket No. CI75-602 also involves a Louisiana producer faced with market value royalty claims based on alleged "market values" in excess of applicable ceiling prices.[24] The problem is not limited to Louisiana producers, however, as shown by Exxon's declaratory order petition in Docket No. RI76-29, which was prompted by market value royalty claims in Texas. Nor is the problem limited only to producers, as is exemplified by the current proceeding in which a pipeline, El Paso Natural Gas Company, has been authorized to increase its rates, subject to refund, to reflect increased overriding royalties based on "market value" payments being made pursuant to a settlement agreement.[25]

The mere pendency of these cases reveals the extent of the problem. The action the Commission has taken in response to these applications reveals that the problem can not be solved simply by reference to precedent involving special relief based on costs other than market value

[24] The problem has also surfaced in a number of producer certificate proceedings in which the Commission has authorized sales of gas pursuant to contracts under whch the purchasers will reimburse the producers for all or some of the amount by which market value royalty lease provisions require the producers to pay royalty in excess of that which would be paid if based on the Commission regulated rates received under the contracts. The Commission has reserved the right to suspend any increase based on these provisions. *Amoco Producing Company, et al.*, Docket No. G-7490, *et al.* (Order issued October 15, 1975); *Texaco Oil Inc., et al.*, Docket No. CI65-407, *et al.* (Order issued October 3, 1975) (Amoco, Marathon and Superior); *Ashland Oil Co., et al.*, Docket No. G-3913, *et al.* (Order issued April 17, 1975) (Amoco); *Exxon Corporation*, Docket No. CI75-263 (Order issued December 30, 1974).

[25] *El Paso Natural Gas Company*, Docket No. RP74-22, *et al*, (Order Issued Nov. 29, 1974), *reh'g denied* (Jan. 29, 1975).

royalty costs. Thus, for example, in the *Huffington* case, the

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Commission has directed that one of the issues to be considered is "the proper treatment of market value royalty costs."[26] If special relief precedent were controlling, there would be no issue as to the proper treatment of market value royalties. Thus the Commission has clearly recognized that market value royalties involve considerations far different than those pertinent to the ordinary special relief case.

The Judge, however, did not consider these differences. For example, in response to Producing's argument that market value royalties will put in Williams' pocket revenue which would otherwise be available for exploration and development, the Judge reasoned that any cost in excess of those used in computing ceiling rates will have the same effect and ceiling rates already take account of this effect. While it may be true that this adverse effect has been considered in establishing most cost components of the ceiling rate, it has not been provided for in the royalty cost component. In computing all cost components except royalties, the Commission considered actual costs, high and low, and reached an average. But in computing the royalty cost average, the Commission did not consider royalties based on prices in excess of the ceiling price and thus market value royalty costs are not taken account of in ceiling prices.

Moreover, it is inherently unreasonable for one governmental agency (the FPC) to allow a price utilizing a price component based on one figure, while another governmental agency (state court) requires actual payment of that

[26] Order Issued July 21, 1975 at 5.

same cost component based on a higher figure. The only other cost component in which this would occur if an actual average were used is the state production and severance tax. And in recognition of the unique nature of such costs, the Commission has always treated state severance taxes as an add on, the amount of which varies as state laws vary.

Finally, one other consideration that distinguishes market value royalty costs from other costs is that it is a flow through item. It is not an operating cost in that it is not incurred until the gas is sold and remuneration received, at which point the revenue is passed directly to the lessor. Again, the only other cost of which this is true is the state severance tax. As already noted, the Commission has recognized the uniqueness of a cost of this nature by its unique treatment of state severance taxes.

Thus it is clear that the circumstances surrounding market value royalty costs are different from those pertinent

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to all other costs except state severance taxes and that those circumstances must be carefully considered in resolving the proper rate treatment of market value royalty costs. The existence of this issue is important to this case because it shows that Producing's application can not be rejected simply by reference to special relief precedent not involving market value royalty costs and because it shows that the just and reasonable price for gas sold from the Williams acreage may ultimately be far in excess of that proposed in the settlement if the settlement is not implemented. At the same time, the resolution of the proper treatment of market value royalty costs is not a part of this case. To the contrary, the very purpose of the settlement agreement and the application based thereon is to dispose of the Williams litigation in a manner satisfactory

to both the litigants and gas consumers without the need to run the risks attendant to an ultimate resolution of the underlying issues involved.

Finally, even if it is ultimately determined that market value royalty costs can not be passed on, adverse resolution of the litigation would have an adverse impact on the consumer. The indisputable fact is that under those circumstances — royalty based on $1.40 but no price increase — funds that would otherwise be available to Producing for exploration and development would instead be funneled into the lessor's hands. As stated by Producing's witness Gray, that result would not benefit anyone except Williams and would do so to the ultimate detriment of gas consumers through a reduction in the capital available for exploration and development. (Tr. 26)

Indeed, Producing's future plan for development of the very acreage which is the subject of this case represents an example of this type of impact. Producing currently plans to drill one development well and to recomplete an existing well during 1976. It is estimated that the development well would produce approximately 1.65 Bcf of gas and, after workover, the recompleted well will produce about 2.42 Bcf. (Tr. 30). Yet, if forced to pay royalty based on $1.40, Producing will defer these development plans indefinitely (Tr. 31).

In sum, at the current price, gas consumers face substantial risks. While the ultimate impact on gas consumers if the Williams case is litigated and resolved adversely to Producing cannot be precisely predicted, two things are quite clear. First, gas consumers can only lose in the event of such an adverse determination. Second, if the lease is terminated, the impact is likely to be devastating. Since these risks can not be avoided so long as the

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current price is in effect, but can be totally avoided by the proposed price increase, the current price is inappropriate.

2. The Amount Of The Price Increase Is Just And Reasonable.

Since the current price is inappropriate, the ultimate question in this case is whether Producing's cost evidence is sufficient to establish that the amount of the price increase which Producing proposes in order to remedy the currently inappropriate price is just and reasonable. As established in *Cities of Fulton* and *American Petrofina,* the factors that are pertinent in making this determination are (1) whether the price increase will generate excess profits and (2) whether the increase is a reasonable price for consumers to pay in order to eliminate the risks which render the current price inappropriate.

On the first point there can be no dispute. Since Producing is currently collecting the applicable ceiling rates, no inquiry into the actual total costs of production is necessary. *American Petrofina, supra.* Thus the only question is whether the increase will generate revenues which will exceed the costs which form the basis for the increase. On this question, the evidence in this case is even clearer than that deemed to be sufficient in *American Petrofina.* In *American Petrofina* there was initially some question as to whether the additional compression which was the basis for the increase would generate profits from the production of additional liquids. Here, there is absolutely no way that the increase will generate any profit for Producing. Every cent of the increase will flow directly through to Williams. There could be no clearer case of lack of excessive profits than this one.

Similarly, the cost evidence clearly establishes that the amount of the increase is more than reasonable in order to avoid the risks associated with the Williams litigation. Producing is currently collecting an average of 40.91¢ per Mcf for gas sold from the Williams acreage. If the flow through alternative is approved, Producing will collect 44.55¢ per Mcf.[27] Thus for a price increase of about 3.64¢ per Mcf, none of which inures to Producing's benefit, the consumer avoids the substantial risks of an adverse resolution of the lawsuit, which are:

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(1) Diversion of all of the gas from the interstate market so that the interstate consumer cannot obtain it at any price.

(2) A price increase of at least 27¢ per Mcf if Williams sells the gas in interstate commerce at the small producer national rate.

(3) Either a price increase far in excess of 3.6¢ per Mcf if the lease is not terminated but royalty payments must be based on $1.40, or diversion to the lessor of substantial amounts of capital otherwise available for exploration and development.

Whether 3.6¢ per Mcf is a reasonable price to pay to avoid these possible results is certainly a matter of judgment, but that judgment must be based on the record. Producing, Shell, and United all presented testimony that the price increase is reasonable and necessary to end the Williams litigation. At the same time, not a single one of United's customers, who will ultimately pay the price increase contemplated by Producing's application or bear the burden of an adverse resolution of the underlying legal issues, has expressed the slightest opposition to Producing's application. The amount of the increase is reasonable and the public interest demands that it be approved.

[27] Late-filed Exhibit 13.

C. The Judge Erred In Rejecting The Abandonment Request.

Producing, as well as Shell and United, views the individualized relief in the form of the royalty flow through as the preferable method for alleviating the problems inherent in the Williams litigation (Tr. 27, 49, 82). In order to place before the Commission all possible means for dealing with the problem, Producing and Shell have also proposed abandonment of the royalty share of the gas as an alternative to the royalty flow through. Under this proposal, Williams would take the royalty share of the gas in kind in settlement of the litigation, thereby eliminating the risk of that litigation.

Under Section 7(b) of the Natural Gas Act, abandonment is appropriate so long as the public convenience and necessity permits. Producing has no quarrel with the Judge's determination that this burden is a heavy one.[28] *Michigan Consolidated Gas Company* v. *FPC*, 283 F.2d 204

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(D.C.Cir. 1960), *cert. denied* 364 U.S. 913 (1960). Indeed, in view of the critical nationwide gas shortage, the need to prevent the diversion of gas dedicated to the interstate market is of the highest priority in protecting gas consumers' interests. And that is precisely why abandonment of the royalty share of the gas is appropriate in this case.

If the choice here were between losing one-eighth of the gas and losing none of the gas there would quite obviously be no issue. But that is not the case. The choice is between losing one-eighth of the gas and risking the loss of all of the gas. If loss of one-eighth of the gas is cause for concern, as it most certainly is, then that concern is increased eightfold when the possibility of losing all of the gas is considered.

[28] Initial Decision at 23, 24.

Thus, under the unique circumstances of this case, the proposed abandonment actually insures the retention of more gas for the interstate market than would rejection of the abandonment. The Judge nonetheless rejected the abandonment proposal. The Judge first observed that the litigation can be settled pursuant to the terms of the settlement agreement even without Commission approval of Producing's application in this proceeding. In fact, the settlement agreement can not be implemented without Commission approval of the application filed pursuant to that agreement. Producing can not and will not agree to a settlement of the litigation on the basis of the present settlement agreement without Commission approval of such application. Moreover, if the Commission does not act so as to allow implementation of the settlement, Williams is no longer bound to its terms. Despite the Judge's conclusion to the contrary,[29] there is not a shred of evidence that even suggests that, if Williams were released from its binding obligation by the Commission's failure to approve Producing's application, Williams would still be willing to settle on the terms contained in the present agreement. The choice therefore is between Commission action which will allow implementation of this settlement agreement and the risks of litigation.

The Judge also concluded, in essence, that unadjudicated claims can never be the basis for abandonment.[30] The Judge cited no authority for this proposition and in fact there is none. To the contrary, an inflexible rule of this nature is directly contrary to the flexible standard of public convenience and necessity set forth under Section 7(b), and the public interest would certainly be disserved by application of a rule which would not allow consideration of the

[29] Initial Decision at 19, 24.

[30] Initial Decision at 24.

factors surrounding the settlement which effect the public interest.

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In addition, a settlement can be the basis for a price increase so long as its terms are reasonable. *El Paso Natural Gas Company, supra.* There is no basis for allowing price relief based on a settlement, but not allowing abandonment based on a settlement when the public interest would be best served by such action.

The Judge also determined that the risk of diversion of the gas from the interstate market is not a significant one. As noted earlier, however, the possibility of loss of the gas is a very real one. El Paso has assessed the risks of market value claims as serious enough to warrant settlement.[31] And the ultimate outcome of the *Southland Royalty* case is very much in doubt.

Thus there is a risk that all of the gas will be diverted from the interstate market, and in fact the Judge did not conclude that there was no such risk. Yet the Judge at no point balanced that risk against the abandonment proposal to determine whether elimination of the risk is more consistent with the public interest than assumption of that risk. Again, this is a matter of judgment. But the judgment of the party with the most direct interest should be entitled to significant weight. In this proceeding that party is United. United's witness Smith, giving due weight to United's already difficult supply situation, testified that, on balance, the risk of losing all of the gas is unacceptable to United and its customers. (Tr. 49)

Finally, the Judge concluded that Producing's abandonment application is based on "self-interest reasoning."[32]

Nothing could be further from the truth. Certainly Producing believes that it will be in a more favorable position if the litigation is settled than if it is not. But that is not the basis for Producing's application. The basis for the application is that the consumer will also be better served by settlement. Surely, that the public interest coincides with Producing's interest is no reason for ignoring the public interest. If the royalty flow through is not allowed, abandonment is in the public interest and should be approved.

D. The Judge Erred In Rejecting The Surcharge Request.

The Judge rejected Producing's surcharge request without considering whether the surcharge is reasonable under the facts of this case. The Judge felt constrained to reject the surcharge without considering the merits because

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(1) the Judge determined that the Commission had already rejected the request in its Order setting the case for hearing, (2) implementation of the settlement is not dependent upon approval of the surcharge, and (3) the Judge viewed the surcharge as a retroactive rate increase. None of these reasons is a valid ground for rejecting the surcharge.

Although the Commission did not specifically refer to the surcharge in setting the price increase request for hearing, certainly all matters relating to the price increase were encompassed by that order. Of course, the surcharge is an integral part of the price increase request. Therefore, while the Commission in its August 29 Order did originally reject the surcharge request, that rejection was necessarily reversed in the Commission's September 22 Order granting rehearing.

Moreover, contrary to the Judge's characterization, the surcharge is not a retroactive rate increase. Rather, it is

prospective adjustment of current prices as part of an overall agreement to eliminate the circumstances which render those current prices inappropriate. As such, it is no different than the surcharge the Commission has allowed El Paso to collect in *El Paso Natural Gas Company*, Docket Nos. RP74-22, *et al.* That surcharge is also a prospective adjustment based on a settlement of market value claims relating to past production. While the propriety of the El Paso surcharge has not been finally resolved, if that surcharge were invalid as a matter of law, as it would be under the Judge's view, then the Commission would have rejected the surcharge rather than allowing its collection subject to refund. Consequently, it is clear that the Judge has misapprehended the nature of the surcharge request and his rejection of the request based on that misapprehension is error.

Finally, whether implementation of the settlement agreement is dependent upon approval of the surcharge request is irrelevant in assessing the propriety of that request. The question is whether the portion of the price increase based on the surcharge is just and reasonable. The surcharge was an integral part of the negotiations leading to the settlement and represents a most reasonable resolution of Williams' claim for alleged past underpayment of royalties. Williams dropped entirely his claim relating to production from October 1971 through December 1973. In addition, as to the remaining claim, the price upon which the royalty is to be based is substantially lower than Williams' alleged market value prices. As a result, the amount of the surcharge is much lower than would be the increase per Mcf if the

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litigation were resolved adversely to Producing and the damages relating to the alleged past underpayments were then passed on.

V.

CONCLUSION

However viewed, market value royalty claims present a difficult problem for both gas consumers and producers. The problem will only become worse however, if it is ignored. It is a practical problem and demands a practical response.

Producing's application provides just such a practical response to the problem as presented by Williams' market value claims. To be sure, that solution will result in a price increase. But that price increase is a fully satisfactory solution to the problem because it eliminates at minimal cost the unacceptable risks to gas consumers inherent in Williams' claims, while at the same time insuring that Producing's profit will not increase a single penny. It is therefore totally consistent with every possible public interest consideration pertinent to this case. The public interest therefore requires approval of the royalty flow through so that

the settlement can be implemented. In the alternative, the abandonment application should be approved.

Respectfully submitted,
Stephen M. Hackerman

A. DUNCAN GRAY, JR.
Vice President and
General Attorney

DIANE BARBER
Pennzoil Producing
Company
900 Southwest Tower
Houston, Texas 77002

JERON STEVENS
STEPHEN M. HACKERMAN
3000 One Shell Plaza
Houston, Texas 77002

BRUCE F. KIELY
Suite 300
1701 Pennsylvania
Ave., N.W.
Washington, D.C. 20006

BAKER & BOTTS
3000 One Shell Plaza
Houston, Texas 77002

Attorneys for
Pennzoil Producing Company

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

PENNZOIL PRODUCING COMPANY
Docket No. RI76-8
SHELL OIL COMPANY
Docket No. RI76-10

BRIEF ON EXCEPTIONS
OF
SHELL OIL COMPANY

Pursuant to Section 1.31 of the Commission's Rules of Practice and Procedure (18 C.F.R. 1.31), Shell Oil Company ("Shell") files its Brief setting out its Exceptions to the Initial Decision of the Presiding Administrative Law Judge issued November 24, 1975, and detailing its reasons in support of those Exceptions.

I.

STATEMENT OF THE CASE

Judge Gordon has accurately set out these specific facts of this proceeding at pages 1 through 6 of his Initial Decision. But he has completely ignored the long procedural background of the "market value royalty problem" discussed at pages 4 through 7 of our Initial Brief, and the fact that this case, together with the *Huffington* (*Roy M. Huffington, Inc.*, Docket No. CI75-602) and *Exxon* (*Exxon Corporation,* Docket No. RI76-29) cases, will be the first opportunity for this Commission to consider one of the major problems which the gas producing industry faces today. Therefore, Shell wishes to supplement the "facts" considered by Judge Gordon with a broader scope of "facts" which we believe the Commission should take into account in reaching its decision here.

We should emphasize at the outset that the relief which Shell seeks, either in permitting the "flow-through" of the additional revenue to be paid the lessor under the settlement, or the abandonment of the lessor's share of the

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gas, will not result in *any* additional revenue to Shell. It will only prevent the occurrence of a "squeeze" on Shell as the lessee-producer, between the rising level of the lessor's royalty demands and the immovable ceiling of the Commission's just and reasonable rate on an area or national basis. Unlike other expenditures made in exploration or production operations, the royalty "cost" in question here could not possibly have been anticipated by Shell. When the first lease was signed in 1934 the Natural Gas Act had not even been passed. When the second lease was signed in 1952, no one, including the Federal Power Commission, believed that its jurisdiction extended over producers at all. Therefore, the royalty provision for a percentage of the "market rate" represented nothing more than an obligation on the lessee to use due diligence to sell the gas from this lease at prevailing market prices. After the first *Phillips* decision[1], there was still no indication that the imposition of Commission regulation on gas producers might result in a different price being permitted for the lessee's share of the gas production than for the lessor's share. It was not until September 20, 1966 when *Huber Corporation* v. *Denman,* 367 F.2d 104 (5th Cir. 1966) and *Weymouth* v. *Colorado Interstate Gas Co.,* 367 F.2d 84 (5th Cir. 1966) were decided that the first indication appeared that the Courts might consider that the lessor was not bound by the Commission's ceiling rates. The Commission attempted to remedy the situation by its Opinion No. 562, *William Harvey Denman, Trustee, et al.* v. *Huber Corporation,* Docket No. RI67-113, 42 F.P.C.

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1 *Phillips Petroleum Co.* v. *Wisconsin,* 347 U.S. 672 (1954).

164, in which it found that it had jurisdiction over the royalty owner's interest in the gas stream. Shell participated actively in the case and supported the imposition that Commission jurisdiction in situations where the lessor sought to receive a different price for his gas than that permitted to be received by the lessee. The Commission's Opinion was reversed by the District of Columbia Circuit in *Mobil Oil Corporation* v. *F.P.C.,* 463 F.2d 256 (1971), by an opinion holding that the Commission had no jurisdiction over the royalty owner's interest in the gas. The District of Columbia Circuit's opinion leaves unanswered several questions which are critical in this case,

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such as whether the lessee can utilize the Commission's ceiling rate as a defense in an action against him by the lessor, and whether the lessor's freedom from jurisdiction will hold as to interest which he acquires by reversion or lease cancellation, after the gas is already moving in interstate commerce.

Finally, the market value royalty question was raised by Mobil Oil Corporation in the *Southern Louisiana Area Rate Proceeding.* In that case Mobil pointed out that the Commission's continued reliance on cost-based rates was resulting in ceiling prices which were less than the market value of the gas being sold, and that as this differential increased the producers' vulnerability to the type of lawsuit involved here increase dramatically. Mobil urged the Commission to consider such royalty demands on an area basis, and make adjustments to the ceiling rate in situations where the royalty owner was able to sustain such demands, through an automatic procedure similar to that utilized by the Commission for increases in state production or severance taxes. The Commission rejected that approach as largely "theoretical" at that time, stating that the producers

would be entitled to file individualized applications for special relief should such royalty owners' demands become a reality. In the case here, the demands *are* a reality, and the Commission is considering in this case, and in the *Exxon* and *Huffington* cases, petitions for special relief, which it told the Fifth Circuit and the Supreme Court were the proper way to handle this problem. The Fifth Circuit clearly set out the parameters which the Commission should follow:

> "If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief. *Permian* contemplated it. FPC has on occasion given it. E. G., Op: 649, 'Opinion and Order Granting Special Relief and Terminating Proceedings" (February 21, 1973). And we find it to be far preferable to speculative prophesies of future royalty components. If the royalty obligations are such as to
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> make the rates established by Op: 598, and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will certainly have recourse to the administrative process. And, as with the moratoria provisions, if FPC determines that future events substantially change the rate structure for the industry as a whole, it may make appropriate changes." (*Placid Oil Co.* v. *F.P.C.*, 483 F.2d at 911)

This language was also quoted in part by the Supreme Court in affirming the Fifth Circuit's decision in *Mobil Oil Corp.* v. *F.P.C.*, 417 U.S. 283, 328 (1974).

Thus, the Commission is not writing on a completely clean slate in this proceeding. It is dealing with a situation which developed through a series of court decisions which could not possibly have been anticipated by the producer at

the time the lease contracts in question were created. It is dealing with a situation which will not result in any increase in revenue to Shell, even if the relief requested is granted. It is dealing with a problem with which it has refused to cope on an area or a national basis, leaving it to individualized applications for special relief.[2] Thus, to deny Shell relief unless it can successfully pursue the phantom of "overall costs", is to effectively refuse to cope with the market value royalty problem. The inevitable result of such a position by the Commission will be a dissipation of industry resources in litigation, the creation of legal clouds of uncertainty over lessee's titles which will preclude additional development operations on these leases, and a reduced supply of gas to the consumer. Judge Gordon's Opinion completely refuses to consider this basic problem, and therefore, must be rejected by the Commission.

II.

SUMMARY OF SHELL'S POSITION

Shell joined in the Comments of "Indicated Producer Respondents" in the National Rate For New Gas Cases, Docket

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No. RM75-14, filed on May 30, 1975, which advocated a provision in the Commission's national ceiling rate for new gas providing for an automatic adjustment of the national ceiling rate for excess market value royalty costs where incurred by the producer. Shell believes that this method

[2] The scope of the market value royalty issue is emphasized by the Notice published in the Federal Register on November 21, 1975 (Fed. Reg. Vol. 40, No. 226, 54268-70), by the U.S. Geological Survey, advising that it intends to fix the value for royalty purposes on onshore Federal and Indian leases at market value, even though this value may exceed the FPC ceiling price at which the gas is being sold.

of dealing with the market value royalty problem is greatly preferable to the "special relief" approach. We believe that this proceeding proves that the special relief approach promulgated by the Commission in the *Southern Louisiana* decision is unworkable, and provides no effective relief for the producer, and restricts and reduces the gas supply to the consumer and will ultimately result in an increase in the consumer costs for the gas stream. Judge Gordon's Initial Decision assumes that "overall costs" are a concrete figure readily ascertainable by Shell and that Shell is negligent in not filing these costs with the Commission. This assumption is completely contrary to fact. As previous Commission decisions have held, these costs are incapable of precise determination, and may vary from a deficit to large profits, depending solely on the methods selected by the cost estimator. To grant or deny "special relief" based on such showing, is to effectively state that special relief procedures are a snare and a delusion and have no practical effect on the industry.

III.

ARGUMENT

A. There Is No Statutory Or Court-Imposed Requirement That A Producer Must Prove That His "Overall" Costs Are Higher Than The Commission's National Or Area Ceiling Rates Or That His Out-of-Pocket Expenses Will Exceed Revenues Before Obtaining Special Relief.

At page 10 of his Decision, Judge Gordon states "the law is clear" that "a producer seeking special relief from area or nationwide prices based on asserted increased costs must establish that his "overall costs incurred in the operation of the particular well or group of wells are higher than the applicable Commission-established area or nationwide ceiling rates, or, even more stringently, that his out-of-pocket expenses will exceed revenues." We do not

believe that Judge Gordon has properly interpreted the cases which he cited. On the contrary, in *Mobil Oil Corp.* v. *F.P.C.*, 417 U.S. 283, 41 L.Ed.2d 72, the Supreme Court stated:

> "Mobil's argument assumes that there is only one just and reasonable rate possible for each vintage of gas, and that this rate must be based entirely on some concept of cost plus a reasonable rate of return. We rejected this argument in Permian Basin and we reject it again here. The Commission explicitly based its additional 'non-cost' incentives on the evidence of a need for increased supplies. Obviously a price sufficient to maintain a producer, while not itself necessarily required by the Act (n. omitted), may not be sufficient also to encourage an increase in production." (41 L.Ed.2d at 99-100)

> Similarly, in *Permian*[3], the Court said:

> "A price is thus just and reasonable within the meaning of § § 4(a) and 5(a) not merely because it is 'somebody's idea of return on a "rate-base,"' (n. omitted) but because it results in satisfactory programs of exploration, development and production." (390 U.S. at 796)

Similarly, in *California* v. *F.P.C.*, 466 F.2d 974 (9th Cir. 1972), the Court rejected an attack on the Commission's area ceiling rate in the Hugoton-Anadarko Area because of the fact that it rested in part on non-cost factors, see 466 F.2d at 989.

It is true, as the Administrative Law Judge states at page 11, that special relief proceedings were limited under the Commission's *Permian Basin* Decision to situations where producers could prove that out-of-pocket expenses were greater than revenues. This policy resulted in no special

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[3] *Permian Basin Area Rate Cases,* 390 U.S. 747 (1968).

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relief applications being granted, as long as it was adhered to by the Commission. By the time the Commission's requirement could be met, the lessee-producer's oil and gas lease was no longer producing in paying quantities, and therefore, he had no reason to seek special relief because he no longer had any lease or production to protect. It was obvious to the producing industry that the Commission had no intention of granting special relief petitions, and so none were filed. Only in recent years, when the Commission has softened this requirement to permit exceptions, has the special relief procedure been utilized at all.

Furthermore, this procedure has not been required for all cost components. In Opinion Nos. 699 and 699-H, the Commission specifically recognized that producers might pay Federal income taxes, and if they paid such taxes, they could file petitions for special relief and receive exceptions from the national ceiling rate, without proving that their other costs were not less than the national average and thus would offset the increase. This finding was specifically affirmed by the Fifth Circuit in *Shell Oil Co. v. F.P.C.*, 520 F.2d 1061, 1080-81 (1975). Furthermore, in all of the area rate decisions, the Commission permitted the producers to collect increases in state production or severance taxes, without any showing of "overall costs" or a showing that producers' costs were not less than the national average. In fact, the entire theory of industry-wide average costs precludes the approach suggested by Judge Gordon's Opinion. If the particular well or set of wells (the size of the project is only one of the unanswered questions) has other exploration and production costs which are above the national average, the addition of the market value royalty clause will clearly place such a producer in a position where he should receive special relief, under Judge

Gordon's Opinion. If on the other hand, the producer's cost for the projects are less than the national average, Judge Gordon's Decision would deny him any additional consideration for market value royalty expense. This is contrary to the approach utilized in the area and national proceedings, as it rewards the high-cost producer and penalizes the efficient producer. The avoidance of this result was one of the primary reasons for the adoption of the area and national ceiling rates in the first place, see *Permian*, 34 F.P.C. at 179.

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B. Denial Of Special Relief In The Absence Of Evidence Of "Overall Costs", Without Defining How Those Costs Are To Be Determined, Or Setting Out Any Of The Parameters By Which Such Determination Is To Be Made, Effectively Eliminates The Special Relief Procedure.

Judge Gordon expresses astonishment that Shell does not know its "overall costs" for the Williams Leases. What is really astonishing is the complete failure of Judge Gordon's Opinion or the Staff's position to come to grips with the problems of the nebulous or non-existent standards for determining these costs. Here are only a few of the questions which must be answered before Shell can have any real knowledge of what figure the Staff or the Judge seek, in asking for "overall costs."

1. The size of the unit involved. We would request the Commission to turn to Exhibit 11, which is a map of the Gibson Field. The two Williams Leases are indicated by the areas colored in red and blue. There is one well located on the 1952 Lease (the area colored in blue). There are ten (10) joint operating units within which all or parts of the Williams Leases are included (see the curved lines on the map). What dollar costs are called for? Are they the costs only of the well

located on the 1952 Lease? Or they the costs of all of the wells in the Gibson Field which are located on any unit which includes any portion of the Williams Leases? There are thirteen (13) wells in the Gibson Field which are included in such units. How many of these wells are to be included in the calculation of joint costs? One of the cases relied on by the Administrative Law Judge, *Macdonald v. F.P.C.*, 505 F.2d 355 (D.C. Cir. 1974), apparently required the submission of company-wide cost data, on the theory that the producer might be able to stand a loss on these particular properties if it was making a profit on other properties under the Commission's national and area ceiling rates. The

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only thing that is made certain by Judge Gordon's Opinion is that, in his view, nationwide costs can*not* be used, as this is what Shell attempted to do.

2. Which of the various methods of estimating costs should be utilized? In its area and national rate decisions, the Commission has utilized at least four separate and distinct methods of estimating unit costs. In *Permian I*, the Commission utilized two separate methods of estimating costs for "old" and "new" gas. In Opinion No. 699-H, the Commission adopted still a third method, utilizing the discounted cash flow method. In recent cost studies submitted in Docket No. RM75-14 by the Bureau of Natural Gas and the Bureau of Economics, additional new methods are suggested to the Commission. The wells drilled in the Gibson Field, in which the Williams Leases participate, were drilled over a time period of some thirty-five (35) years. Which of the various cost methods should be utilized for the different wells involved? How are lease acquisition costs, unsuccessful well costs, and geological and geophysical expenses to be allocated? None of these questions are answered by any decision cited by Judge Gordon, or by the Staff, or by the Judge in his Initial Decision. Indeed when queried on the meaning of "overall costs" demanded in this proceeding, the Com-

mission Staff counsel could only say that the "unit cost of gas based on the actual cost associated with the properties involved" (Tr. 116) was required.

3. Assuming the size of the unit and the costing method could be determined, which are obviously impossible under the current Commission rules, all of the difficult problems of allocation of joint costs between liquid hydrocarbons and natural gas remain. Wells in the Gibson Field produce crude oil and liquefiable hydrocarbons. How are the joint costs of wells producing both oil and gas to be allocated? Is the relative cost method to be utilized? Is the liquid credit method to be utilized? Is the sales realization method to be utilized? If so, what value should be attributed to the respective quantities of oil and gas?

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4. There is yet another dimension of the costing problem in addition to the foregoing questions. This is the question of the denominator to be utilized in the unit cost estimate. Is the denominator production of gas on the daily, monthly, or yearly basis? Or is the denominator the amount of reserves added by each well? Or the denominator the amount of reserves remaining in the Gibson Field? Or is the denominator the amount of reserves attributable to the Williams Leases?

Until the Commission determines the ground rules to be followed, and answers some of the questions listed above, the ability of any producer to meet the requirement of justifying his application for special relief by "overall costs" is not difficult — it is impossible. The only practical answer is that any cost study filed by the producer is wrong, if it indicates a result which is above the Commission's ceiling rate. If this is the result which the Commission intends, then it should clearly and truthfully say so, and not hold out false hopes to the producer and the Congress.

that some change can be made in the ceiling rates through special relief proceedings. The reason for cost imprecision and costing methods were clearly explained by the Commission in its *Texas Gulf Coast Area Rate Case*, 45 F.P.C. 674, where the Commission discussed for some eleven pages (45 F.P.C. 691-702) the various elements of imprecision in only one of the three costing methods which it has utilized. We urge the Commission to reread again this discussion, and conclude, as the Commission did at 45 F.P.C. at 702-03, that "cost calculations are not 'costs' in the direct sense, but rather judgmental choices of data, and judgmental choices of allocation of joint costs."

C. The End Result Test — What Is In The Best Interest Of The Consumer?

All of the major rate cases, beginning with the *Hope* case[4] through *Permian* and *Mobil*, and all of the area rate decisions in the Circuit Courts, emphasize that the

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Commission should consider the end result of its actions, and that its efforts should be to obtain an adequate supply of gas at a reasonable cost. We submit that the Initial Decision here completely loses sight of that objective, and instead adopts a course of action which inevitably must restrict supply and increase consumer costs.

1. The Question Of Gas Supply.

The evidence in this proceeding shows that not only Shell but also Pennzoil Producing Comapny ("Pennzoil") and United Gas Pipe Line Company ("United"), the pipeline purchaser, view with extreme seriousness the action by the

[4] *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944).

Williams to cancel the lease or to base their royalty payments on the current market of gas, which they have contended to be $1.40 per Mcf. If the Louisiana State Court should deny the lessors' claim for cancellation but grant it claim for royalty based on market value, the 1952 Lease would have to be released, as there is a net revenue deficit on this Lease of 3.15 cents per Mcf for each cubic foot of gas sold after such a judgment. Judge Gordon dismisses the concern expressed by all of the parties except the Commission Staff for the possible loss of the entire gas stream to the interstate market by the following reasoning:

(a) Shell may prevail in its lawsuit against the lessors;

(b) Shell can still accept the settlement rate of 78 cents per Mcf without its royalty and operating costs exceeding its net revenues; and

(c) Even if the lessors get the title to all of the gas, the gas must stay in interstate commerce under the Commission's decision in *El Paso Natural Gas Company*, Opinion Nos. 737 and 737-A, issued July 11, 1975 and September 3, 1975, respectively.

It is noteworthy with United, faced with severe curtailment problems, does not share the analysis of the

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public interest adopted by Commission Staff and Judge Gordon. On the contrary, United views with extreme seriousness the possibility of losing a substantial portion of its gas supply, see Tr. 65-67. It is also noteworthy that no consumer has intervened in opposition to Shell's Petition. On the first point made by the Presiding Judge, the probability of prevailing in State Court in the lawsuit against the Wil-

liams, Shell will not, for obvious reasons, attempt to brief this issue to the Commission from the viewpoint of its opponent in the State Court, the lessor-royalty owner.

The Presiding Judge is also in error in his interpretation of the settlement and his conclusion that if Shell and Pennzoil are willing to pay royalty based on a 78-cent price that the Williams will have to accept it and settle the litigation. On the contrary, the settlement agreement provides that the Williams are entitled to the *higher* of the base royalty rate of 78 cents or the "base alternative rate", which is defined as 150 percent of the highest area of national rate permitted. Under the current National Rate For New Gas, this rate level is approximately 90 cents per Mcf. Should the Commission in Docket No. RM75-14, the Biennial Review Proceeding, increase the national rate, this alternative rate will go up to 150 percent of whatever the new national ceiling rate may be. Therefore, the Williams also would have the right to reject the settlement even if Shell and Pennzoil were willing to pay royalty on the basis of 78 cents per Mcf.

On the third question, whether the gas must continue to be sold to United in interstate commerce if the Williams are successful in obtaining title to the leases, the outcome is also far from certain. The *El Paso* case is currently pending on appeal in the Fifth Circuit, see *Southland Royalty Company* v. *F.P.C.*, Case No. 75-2851. Moreover, under *Mobil Oil Corporation* v. *F.P.C.*, 463 F.2d 256 (D.C. Cir. 1971), cert. denied, 92 S.Ct. 2409, the reversion of the lease to the lessor, so that under the "merger" doctrine the lessor owns the full title to the property, may remove the entire gas stream from FPC jurisdiction.

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In all of the uncertainty as to the ultimate question of how much gas will remain in interstate commerce, one thing

is certain — the outcome of the various lawsuits required to resolve the above question will remain in doubt for several years in the future. The testimony in this case shows clearly that one well has been deferred for some three years because of this litigation, and that Pennzoil is also contemplating some development wells which cannot be drilled until the cloud of the lawsuit has been removed. As long as the litigation continues, additional capital investments cannot be made on the leases in question. Thus, the production from the reservoirs must be allowed to decline and with the resulting deterioration of United's supply. All of this effect is discounted by Judge Gordon by the statement that Shell refused to "promise" that it would engage in additional development should the special relief be granted. What Shell did say was that it had planned and budgeted a well on the Williams' Leases at the time the litigation was commenced. After a lapse of some three years, in today's inflationary economy, it is necessary to re-evaluate the costs involved against the revenues hopefully to be received before an affirmative commitment can be made. Such an evaluation cannot be made until the Commission's decision is issued and the circumstances are known.

2. The Question Of Cost To The Consumer.

If the Commission were to grant the special relief requested, to flow through the higher royalty cost, in the case of Shell there would be an increase in the ceiling of 3.6 cents per Mcf under the 1934 Lease and 9 cents under the 1952 Lease (Initial Decision, p. 9). Should the Williams succeed, either in canceling Shell's lease or in obtaining a royalty payment based on the price which is so high that Shell could not continue to operate the lease, the Williams would then succeed to eight-eighths (8/8ths) of the production attributable to these leases. If the Commission

were to prevail and subsequent litigation with Williams under the theory set out in the *El Paso* decision, *supra*, so that the gas must continue to be sold in interstate commerce, there still remains a question of the price at which such gas

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would be sold. Under existing Commission decisions, Williams would have no contract to sell gas to United, as the contract would terminate at the same time Shell's lease terminates. Should the Williams thereafter enter into a new contract with United, under the Commission's Opinion Nos. 699 and 699-H, all of this gas would be entitled to the National Rate For New Gas, currently at 58-59 cents (including Btu adjustment). As this price would be received for the full eight-eighths (8/8ths) of the production, not one-eighth (1/8th) or one-fourth (1/4th) of such production, the overall price to the consumer would be 16.4 cents per Mcf *higher* under this result than under Shell's proposal for the 1934 Lease and 8.4 cents per Mcf *higher* for each Mcf sold under the 1952 Lease, compared to Shell's proposal. If the Williams were successful in obtaining a small producer certificate, the differential would be even greater.[5]

Judge Gordon's conclusion is to require Shell to continue to operate the leases, even though its gas revenues are at a loss, and subsidize its gas operation by sale of the liquid products. Depending on the price ultimately determined as the basis for the calculation of royalty, this course represents a marginal operation at best and at worst, illegal confiscation.

[5] Judge Gordon concludes that the Williams would not be entitled to a small producer certificate because current gas sales attributable to the leases in question exceed 10 million Mcf per year (p. 22). He does not address the question of how long the current production rate will continue in the absence of further capital investment on these leases. There is certainly no reason to expect that the current rate of production will continue for some indefinite period in the future.

IV.
CONCLUSION

This case will be one of the first considered by the new Dunham Commission. Writing on virtually a

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clean slate, this Commission must decide whether it will follow the policies of the Nassikas Commission and attempt to weigh the effects of its decisions on the gas supply, viewing the consumer interests in its broader aspect, or whether it will revert to the theory practiced by the Swidler and White Commissions of holding producer prices strictly to cost determinations, which are admittedly imprecise, and rest on judgmental selections of methods designed to obtain the lowest possible result. It requires but a brief look at history to see the result of these two alternative policy positions by the Commission. The policy of the Swidler-White Commission led to reduced prices, reduced supply, increased demand, and the gas crisis of mounting proportions. The policy of the Nassikas Commission attempted to reverse that trend, and has been successful in increasing the exploration and production effort by the industry, although this increased effort is not still enough to keep up with increased demand. As charged by the Court decisions, we urge the Commission to carefully consider the "end result" of its decision in this proceeding.

Respectfully submitted,

THOMAS G. JOHNSON
WILLIAM G. RIDDOCH
Attorneys for
SHELL OIL COMPANY
By /s/ THOMAS G. JOHNSON
Thomas G. Johnson

December 19, 1975

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners:
Richard L. Dunham, Chairman;
Don S. Smith, John H. Holloman III,
and James G. Watt.

Pennzoil Producing Company
Docket No. RI76-8
Shell Oil Company
Docket No. RI76-10

OPINION NO. 753
OPINION AND ORDER
DENYING SPECIAL RELIEF AND ABANDONMENT

(Issued January 30, 1976)

Pennzoil Producing Company (Pennzoil) on July 1, 1975, and Shell Oil Company (Shell) on July 18, 1975, filed applications seeking special relief from the just and reasonable rates[1] established under Opinion Nos. 598[2] and 699[3] in order to flow through to their customer, United Gas Pipe Line

[1] Sections 4(a) and 5(a) of the Natural Gas Act, require that all rates received by a "natural gas company" be "just and reasonable". 52 Stat. 822, 823 (1938); 15 U.S.C. §§ 717c(a), 717d(a) (1970).
See, e.g., FPC v. *Texaco Inc.*, 417 U.S. 380 (1974).

[2] *Area Rate Proceeding et al. (Southern Louisiana Area)*, 46 FPC 86 (1971), *aff'd sub nom. Placid Oil Co.* v. *FPC*, 483 F.2d 880 (5th Cir. 1973); *aff'd sub nom. Mobil Oil Corp.* v. *FPC* 417 U.S. 283 (1974).

[3] *Just And Reasonable National Rates For Sales Of Natural Gas From Wells Commenced On Or After January 1, 1973, And New Dedications To Interstate Commerce On Or After January 1, 1973*, Docket No. R-389-B, Opinion No. 699, 51 F.P.C. 2212 (June 21, 1974), *reh. denied*, Opinion No. 699-H, 52 F.P.C. (December 4, 1974, *aff'd sub nom. Shell Oil Co.* v. *FPC*, 520 F.2d 1061 (5th Cir. 1975).

Company (United), higher royalty rates called for in a settlement agreement dated June 18, 1975, with their lessors, Williams, Inc. and others (Williams).

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The gas involved is produced in the Gibson Field, Terrebonne Parish, Louisiana, from leases with Williams dated August 29, 1934, and July 24, 1952. The 1934 lease provides for payment of a royalty equal to one eighth (1/8) of the value of the gas produced calculated at the "market rate" prevailing at the well. The 1952 lease provided for a royalty of one-fourth of the value of the gas calculated at the "market price" prevailing at the well. By letters dated June 7, 1973, and March 27, 1974, Williams demanded payment by Shell and Pennzoil of royalties based on market values ranging from 35 cents to 70 cents per Mcf for the period October 1, 1971, through December 31, 1973, and 70 cents per Mcf thereafter. By letter of June 5, 1974, Williams purported to terminate the leases (Exhibit No. 3).

On May 24, 1974, Shell and Pennzoil filed a petition in the Civil District Court in the Parish of Orleans, Louisiana[4] praying for a Judgment declaring that the petitioner's interpretation of "market rate" and "market price" was correct, that they have properly discharged their royalty obligations on the basis of Commission established rates and that the leases are still in effect (Exhibit No. 4). They also asked for a temporary restraining order which was granted. Williams filed an answer and reconventional demand (counterclaim), with an amendment alleging market prices for the gas for the period October 1, 1971, to April 30, 1975, ranging from $.35 to $1.40 per Mcf and underpayments of $3,731,683.79 (Exhibit Nos. 5, 6).

[4] *Shell Oil Company and Pennzoil Producing Company* v. *Williams Inc., et al*, Civ. D.Ct. Orleans Parish, La., Docket No. 573-581.

In the settlement of June 18, 1975, Pennzoil and Shell would apply to the Commission for authority to pay a royalty based on a price of 78 cents per Mcf for 1975 and 1.5 cents per Mcf more each year or 150 percent of the highest area or national rate permitted, plus Louisiana severance tax, Federal taxes and Btu adjustment. Alternatively, Pennzoil and Shell would ask for authority to deliver to Williams one-eighth or one-fourth, as the case may be, of the gas attributable to their respective interests, and to abandon their sales of this gas to United.

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If the Commission approves the price alternative, Pennzoil and Shell would pay a royalty for 1974 equal to what would have been paid based on a price of 45 cents per Mcf, but only to the extent the Commission permits them to recover such amounts from United. If the Commission approves the alternative delivery of the gas to Williams, Pennzoil and Shell would pay an additional royalty until the date of a final order.

After the Commission's order becomes final and non-appealable the parties would dismiss their Louisiana civil suit. Pennzoil and Shell are to use their best efforts to obtain the approval of the Commission. If the Commission refuses to do so on or before February 1, 1976, either Williams or Shell and Pennzoil, acting together, may terminate the agreement. In separate agreements United agreed to make the additional payments or to release the royalty gas (Exhibit Nos. 7, 8).

In its order of August 29, 1975, the Commission denied the petitions of Pennzoil and Shell for special relief and prescribed a hearing on the issue relating to the abandonment of the royalty gas. On September 22, 1975, the Commission granted rehearing and provided that the hearing cover the issue of special relief. The hearing was held

before Presiding Administrative Law Judge Samuel Z. Gordon on September 23, 1975, at which Shell, Pennzoil and United presented evidence. Shell was afforded additional time to present certain factual data as to prices, volumes and cost and did so on September 29, 1975. The costs it presented were derived from national costs with a figure for operating expenses from the 1934 and 1952 leases substituted for the national figure. Shell was given opportunity to file additional cost data but advised that it did not intend to do so (Exhibit No. 10), although it filed answers to written interrogatories submitted by the Commission staff.

In his initial decision issued November 24, 1975, the Judge denied special relief on the ground that the producer must establish that his overall costs incurred in the operation of the particular well or group of wells are higher than area or nationwide rates, or that his out-of-pocket expenses will exceed revenues. Pennzoil, he said, had made no such showing and Shell had attempted to use the nationwide costs with a 4.5 cents figure for operating costs and a royalty figure based on $1.40 per Mcf market value.

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The Judge also determined that Pennzoil and Shell have not established that abandonment of the royalty interest is permitted by the public convenience and necessity. Williams has agreed to accept higher royalty payments computed on the basis of 78 cents per Mcf, he pointed out, and Shell has shown that it could absorb higher royalty costs while Pennzoil has not made a showing that it could not. Furthermore, the abandonment should be denied because William's claim is unadjudicated. He would also deny the requested surcharge for past royalties.

Exceptions were filed by Pennzoil, Shell, United, Mobil Oil Corporation (adopting those of Pennzoil and Shell) and

the State of Louisiana, and a brief opposing exceptions was filed by Staff.

Since the filing of the exceptions Pennzoil on January 20, 1976, filed a motion for leave to lodge a document with the Commission and to comment on the Commission's Opinion No. 749[5] prescribing rates for flowing gas. The document is a letter dated January 5, 1976, from counsel for Williams requesting answers to interrogatories in the Louisiana litigation and stating that Williams intended to reactivate the state proceedings as soon as possible under the settlement agreement. In its comments on Opinion No. 749 Pennzoil says that, as to the old gas, the royalty increment under the settlement would be added to the Opinion No. 749 rate,[6] rather than to the Southern Louisiana Area rate. Pennzoil argues that the Opinion No. 749 rate[6] should apply even though it is granted special relief here[7] because this is not a typical relief case since all increased sums will be passed directly to the lessors. Since we are denying the requested relief as discussed below, it is not necessary to determine this issue.

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Pennzoil objects to the Judge requiring project cost evidence, saying that the cost inquiry should be limited to the costs and revenues associated with the price increase. It argues that the risks of the Williams litigation render the current price inappropriate and lease termination is a serious possibility. If Williams wins in the litigation,

[5] *Just And Reasonable National Rates For Sales Of Natural Gas From Wells Commenced Prior To January 1, 1973*, FPC Opinion No. 749, Docket No. R-478, F.P.C. (December 31, 1975).

[6] The Opinion No. 749 rate is 23.5 cents per Mcf 23.5 cents per Mcf prior to July 1, 1976, and 29.5 cents per Mcf thereafter, subject to adjustments.

[7] See Opinion No. 749, at 48-49.

Pennzoil says, it might be able to sell the gas in intrastate commerce, or it might sell all of the gas under a new contract at 130 percent of the national rate under Section 2.56a(a)(2)(iii) of the Regulations[8] and Opinion No. 742[9], and for all of the gas this would be 27 cents per Mcf more than Pennzoil is currently collecting. It further contends that market value royalties involve considerations different from those involved in the determination of other items of cost since royalties are flowed-through to the lessor. Finally, its notes that substantial risks are avoided by an increase in average price from 40.91 cents per Mcf to 44.55 cents per Mcf or 3.64 cents, none of which inures to Pennzoil's benefit.

Shell makes similar arguments about the lack of necessity for showing overall costs, saying that proof of overall costs is not required in a special relief case. Likewise Shell argues that failure to approve the settlement risks interstate gas supply and threatens higher prices, and asks the Commission to consider the end result. United urges that the settlement be approved in the public interest as concerned with the certainty of gas supply and reasonable prices. Louisiana argues that the Judge failed to apply proper standards in denying rate relief contending that changed circumstances have made no longer appropriate the royalty cost assumptions that went into the applicable rate structures, and Louisiana supports the settlement as a reasonable and appropriate resolution of the issues. On the other hand the staff argues against reliance on non-cost

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factors and Shell's use of national cost figures, which it points out are only averages.

[8] 18 C.F.R. § 2.56a(a)(2)(iii).

[9] *Small Producer Regulation*, Docket No. R-393, Opinion No. 742, FPC

PRICE RELIEF

The real issue in this proceeding is whether the Federal Power Commission can legally grant any form of rate relief above either an area or nationwide just and reasonable rate solely because the producer selling the gas in interstate commerce *may* be obligated to make a royalty payment based not upon the regulated price the producer receives for the gas, but rather on the "market value" of the gas. Moreover, as in this proceeding, the question becomes somewhat speculative because of litigation between producer lessees and lessors over the extent of such royalty obligations.

While sympathetic to the plight of the producers who face or may face litigation on the value of royalties, we today must find that such producers are not entitled to rate relief. While we admittedly do not have jurisdiction over royalty owners as such[10] and, therefore, over royalty payments by producers to lease owners, we do have jurisdiction over the rates charged by producers to the pipelines for sales of gas for resale in interstate commerce and those rates must be "just and reasonable".[11] Hence, if a producer desires to compute royalty payments based on a rate in excess of our applicable just and reasonable rate, he may unilaterally do so. However, if a producer attempts to flow this cost through to the pipeline and ultimately to the consumer, we must determine if this *incremental royalty cost* is just and reasonable. Yet, in making this finding, it would be inconsistent and contrary to the Commission's mandate to establish a just and reasonable rate and at the same time allow a producer selling at that just and reasonable rate to increase this rate for additional royalty payments which are based on other factors than the regulated rate.

[10] See *Mobil Oil Corporation* v. *FPC*, 4[illegible] F.2d 256 (D.C. Cir. 1972).

[11] See *Mobil Oil Corporation* v. *FPC*, *et al.*, 417 U.S. 283 (1974); *FPC* v. *Texaco, Inc.*, 417 U.S. 380 (1974).

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In the instant proceeding, the impetus of the settlement is the market value of the royalties and no consideration has been given to regulated rates. As such, we cannot permit any incremental royalty costs resulting from this settlement, or resulting from any judgment by a state court regarding royalty payments, to be passed on to the pipeline if these incremental royalty costs are based on any other factors than the regulated just and reasonable rate. On this point, we note the Supreme Court's warning in *FPC* v. *Texaco, supra*, that the Commission is not free to equate just and reasonable rates with the prices for gas in the marketplace. Accordingly, we believe that we are not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates. A contrary result would not "... afford customers a complete, permanent, and effective bond of protection from excessive rates and charges".[12]

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ABANDONMENT

Pennzoil argues that abandonment of the royalty portion of the gas should be allowed under Section 7(b) of the Natural Gas Act[13] as in the public convenience and necessity if price relief is not granted. Pennzoil says the choice here is

[12] See *Atlantic Refining Company* v. *Public Service Commission of the State of New York*, 360 U.S. 378, 388 (1959).

[13] Section 7(b) provides:

> No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

52 Stat. 824 (1938); 15 U.S.C. § 717f(b) (1970).

between losing one-eighth of the gas and risking the loss of all of the gas. While United prefers the requests for increased rates, it says the Commission should approve the requests to abandon the royalty portion of the gas if price relief is denied.

We find no reason to grant abandonment on the basis of this record. There is no showing "that the available supply of natural gas is depleted to the extent that the continuation of service is unwarranted, or that the present or future public convenience or necessity" requires that abandonment be authorized.

The supply of natural gas involved in this case is not depleted so abandonment may not be approved for that reason. Moreover, the public convenience and necessity, present or future, is not served by granting an abandonment authorization that would likely result in the subject gas being diverted from the interstate market to the intrastate market.

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Since "there can be no withdrawal of that supply [of natural gas] from continued interstate movement without Commission approval"[14] once the gas is dedicated, we do not share the concern of Pennzoil and United that Williams could terminate deliveries to United even if the leases were cancelled as a result of state court litigation. If the lease were cancelled and Williams were to undertake to sell the subject gas, Williams would simply assume the obligations of Pennzoil and Shell to continue service to United. *El Paso Natural Gas Company, Texaco Inc.*, Docket Nos. CP75-209, CI75-594, Opinion No. 737, ___ F.P.C. ___ (July 11, 1975), *rehearing denied,* Opinion No. 737-A, ___ F.P.C. ___ (September 3, 1975), *rehearing granted* on limited issue, Opinion No. 737-B, ___ F.P.C. ___ (December 18, 1975), *appeal*

[14] *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378, 389 (1959).

pending sub nom. Southland Royalty Co. v. *F.P.C.*, No. 75-2851 (5th Cir.). In such a case, Williams would not be entitled to the status afforded a royalty owner by *Mobil Oil Corp.* v. *F.P.C.*, 463 F.2d 256 (D.C. Cir. 1971), but would be a natural gas company making sales for resale of natural gas in interstate commerce subject to the Commission's jurisdiction. *Phillips Petroleum Company* v. *Wisconsin*, 347 U.S. 672 (1954). We, therefore, deny the alternative requests for abandonment.

SURCHARGE

Pennzoil argues that the surcharge contained in the settlement to pay Williams for alleged past underpayment of royalties was not settled in the Commission's orders, is not a retroactive rate increase, represents less than the full

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claim and should be allowed. For the reasons set forth above in denying the requested price relief, we also deny the requested surcharge.

The Commission further finds:

The initial decision issued November 24, 1975, in these proceedings denying the applications of Pennzoil and Shell for special relief or abandonment, and a surcharge should be affirmed for the reasons set forth above.

The Commission orders:

(A) The initial decision issued November 24, 1975, in these proceedings is affirmed for the reasons set forth above.

(B) The petitions of Pennzoil and Shell requesting special relief or abandonment and a surcharge are denied.

(C) The motion to lodge a document and comment filed on January 20, 1976, is granted.

(D) Exceptions not granted are denied.

By the Commission.

(SEAL)

Kenneth F. Plumb,
Secretary.

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

PENNZOIL PRODUCING COMPANY
Docket No. RI76-8

SHELL OIL COMPANY
Docket No. RI76-10

PENNZOIL PRODUCING COMPANY'S
PETITION FOR REHEARING

Pursuant to Section 19(a) of the Natural Gas Act and Section 1.34 of the Commission's Rules of Practice and Procedure, Pennzoil Producing Company (Producing) hereby petitions the Commission for rehearing of its Opinion No. 753 issued in this proceeding on January 30, 1975, and respectfully requests expedited treatment of this petition in order that a decision on rehearing may be issued no later than March 1, 1976.

In support hereof, Producing respectfully states:

I.

INTRODUCTION

Producing is selling at applicable Commission ceiling prices gas produced from acreage leased from Williams, Inc. (Williams). Producing is paying royalty to Williams based on the ceiling rates Producing is collecting for the sale of the Williams acreage gas, but Williams has demanded royalty payments based on prices in excess of such rates. Litigation has resulted in which Williams seeks to have a Louisiana state court (1) declare the lease terminated and (2) assess damages for alleged underpayment of royalties. Producing has asked the court to enjoin Williams from terminating the lease and to declare that Producing has been and is paying the correct royalty.

By its application in this proceeding, Producing seeks Commission action which will allow implementation of an agreement in settlement of the Williams litigation. The settlement can be implemented if the Commission authorizes Producing to increase the price charged for gas sold from the Williams acreage in an amount exactly equal to the increased royalty payments that Producing would make to

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Williams under the settlement. Royalties under the settlement would be based on the higher of 78¢ per Mcf[1] or 150% of the highest national or area rate permitted. In the alternative, the settlement can be implemented if the Commission authorizes abandonment of the sale of the royalty share of the gas so that Williams may take that royalty share in kind. In Opinion No. 753, the Commission rejected both alternative requests. In addition, although the issue was not presented in this case, the Commission stated that it had no authority to allow a producer to reflect in its rates excess royalty costs even when such costs are incurred as a result of a court judgment.

The settlement which forms the basis for Producing's application provides that either party may cancel the agreement if the requisite Commission authorization is not obtained by February 1, 1976. While that date is now past, Producing firmly believes that the Commission erred in rejecting the application. Therefore, Producing has sought and received Williams' assurance that although the Wil-

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[1] Plus 1.5¢ annual escalations beginning January 1, 1976. In addition, Producing seeks approval to collect a surcharge that would also be passed through to Williams under the settlement. The surcharge is in settlement of Williams' claims as to alleged past underpayment of royalties and represents an amount far less than Williams claims. Implementation of the settlement is not dependent upon approval of the surcharge.

liams litigation will now proceed, the settlement will not be cancelled before March 1, 1976. Consequently, should the Commission on rehearing, on or before March 1, 1976, authorize the royalty flow through or the abandonment request, the settlement may still be implemented.

II.

SPECIFICATION OF ERRORS

A. **The Commission Erred In Denying Producing's Excess Royalty Flow Through Request.**

B. **The Commission Erred In Stating In Dicta That Excess Royalty Costs Incurred As A Result Of A Court Judgment May Not Be Recovered In Producer Rates.**

C. **The Commission Erred In Denying The Alternative Abandonment Request.**

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D. **The Commission Erred In Denying The Surcharge Request.**

III.

ARGUMENT

A. **The Commission Erred In Denying Producing's Excess Royalty Flow Through Request.**

1. **The Commission Has Authority to Allow Increased Rates to Reflect Royalty Payments Based on Prices in Excess of Ceiling Rates.**

In rejecting the excess royalty flow through, the Commission expressed concern for the problems created by excess market value royalty litigation. In addition, the Commission held that in passing upon rate increase requests based solely upon such costs "... we must determine if this *incremental royalty cost* is just and reasonable." Opinion No. 753 at 6 (emphasis in original). Producing has no quarrel with these two findings. Yet despite establishing this stand-

ard, which of necessity requires a determination of whether the incremental excess royalty costs were prudently incurred, the Commission concluded that the Natural Gas Act precludes recovery of such costs regardless of the circumstances under which they were incurred. On this point the Commission erred.

Both the United States Supreme Court and the Fifth Circuit have already held that the Commission does have authority to allow rate adjustments to reflect royalty costs based on prices in excess of Commission ceiling prices. *Placid Oil Co.* v. *FPC,* 383 F.2d 880 (5th Cir. 1973), aff'd. *sub nom. Mobil Oil Corp.* v. *FPC,* 417 U.S. 283 (1974). That determination was made in the context of the review of the Commission's Opinion No. 598 which established an area rate for Southern Louisiana. Mobil Oil Corporation contended that the royalty component of the rate there established was inadequate because it failed to take account of the possibility of the precise type of royalty costs involved in this proceeding, *i.e.,* royalties based on prices in excess of the ceiling rate. The Fifth Circuit responded to this contention by holding that the royalty component was adequate since not all producers faced excess royalty costs and those who did had the opportunity to obtain relief through individualized proceedings:

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> If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may *certainly* petition FPC for individualized relief.
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> * * * *
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> If the royalty obligations are such as to make the rates established by Op: 598, and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will *certainly* have recourse to the administrative process. 483 F.2d at 911 (emphasis added).

The Supreme Court spoke to this precise point, and affirmed the Fifth Circuit's determination that individualized relief is an available remedy for royalty costs based on prices in excess of ceiling rates, holding that "... an affected producer is entitled to seek individualized relief." 417 U.S. at 328.

Producing does not contend that *Placid Oil* and *Mobil Oil* establish the prudence of the excess royalty costs in this case. The evidence establishes that fact. But without question *Placid Oil* and *Mobil Oil* do establish that the Commission has the authority to allow price relief for royalty costs based on prices in excess of ceiling rates. The Commission's determination to the contrary, which was the sole basis for rejecting the royalty flow through, is therefore erroneous.

The Commission's determination that it has no authority to allow flow through of excess royalty costs was based on the view that "the Commission is not free to equate just and reasonable rates with the prices for gas in the marketplace", citing *FPC* v. *Texaco,* 417 U.S. 380 (1974). The Supreme Court, however, certainly saw nothing in this general principle that would preclude flow through of excess market value royalty costs since the Court's determination in *Mobil Oil* that a producer can seek rate relief on the basis of such costs was made the same day *Texaco* was decided.

In fact, the *Texaco* decision fully supports Producing's position in this case. To be sure, the Court did state the general rule that an entire rate cannot be based *solely* on market prices. But the Court was careful to discuss the reason for this rule and the resulting limitations on the rule. The Court pointed out that the reason for the rule is that the basic premise of the Natural Gas Act is that market prices will generally be too high, *i.e.,* generate "excess profits." Thus the basic purpose of the Act was to

protect consumers from rates which allowed "excess profits." Yet if an entire rate is based solely on market prices, no basis for determining the level of profits will generally exist. By the same token, if the reason for the rule, *i.e.,* no evidence as to profits, is not present in an individual case the rule has no application:

> "This does not mean that the market price of gas would never, in an individual case, coincide with just and reasonable rates or not be a relevant consideration in the setting of area rates ...; it may certainly be taken into account along with other factors, ..." 417 U.S. at 380.

The price increase request in this case is not based solely on market prices. To the contrary, it is based on a number of factors, including the risks of the Williams litigation, the propriety of the settlement, and the absence of any excess profit to Producing as a result of the price increase. Producing would continue to receive for itself only the revenue found by the Commission in the various area and national rate cases to be just and reasonable. Moreover, the amount of the price increase is not based on market prices. It is based on prices far below intrastate prices. Thus market price considerations are involved only to the extent that they gave rise to the litigation. Under *Texaco,* far from precluding the relief Producing seeks, that fact is simply "a relevant consideration" that must be weighed in Producing's favor.

Furthermore, as recognized in *Texaco* there may be individual cases in which a price increase based solely on market prices will be just and reasonable. Of course, one such case would be when the evidence establishes that the price does not allow "excess profits". The incremental price increase in this case is based on exact incremental costs, and

none of the revenue generated by that price increase inures to Producing's benefit. Thus, even if the incremental price increase in this case were viewed as based solely on market prices, under *Texaco* it would still be just and reasonable because the uncontroverted evidence establishes that Producing's profit will not increase one cent.

The Courts of Appeals have reached the same result as *Texaco* and for the same reason. For example, in *Consumers Federation of America* v. FPC, 515 F.2d 347 (D.C. Cir. 1975), the Court held that a rate collected under Order No. 491 cannot be deemed just and reasonable *solely* by reference to market prices. Similarly, in *MacDonald* v. *FPC,* 505 F.2d 355 (D.C Cir. 1974), the Court stated that the entire special

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relief rate there involved could not be justified *solely* by reference to market prices. Again, the Court noted that if the rate were established solely on the basis of market prices, the level of the producer's profits could not be ascertained, thereby permitting a result possibly inconsistent with the basic purpose of the Gas Act, which was said to be the "protection of the consumer from profiteering in the gas industry." 505 F.2d 363.

Thus the Courts have held only that an entire rate may not be deemed to be just and reasonable based *solely* on market prices when there is no evidence as to the producer's profits under that rate. The justness and reasonableness of an incremental price increase reflecting exactly corresponding incremental costs based in part on market price considerations is an entirely different question. When an entire rate is under consideration as it was in *Texaco, MacDonald,* and *Consumers Federation,* then the level of profits is also involved. But when only an incremental cost is involved, no

question of "excessive profits" exists. By its very nature, a price increased based on incremental costs cannot possibly generate "excess profits" because the increased revenue will be sufficient only to cover the exact amount of the increased costs. Therefore, when the question is simply whether an incremental cost is just and reasonable, as the Commission has stated the issue to be here, the general rule proscribing a rate based solely on market prices is inapplicable. The Supreme Court's holding in *Mobil Oil* that individualized price relief is available for royalty costs based on prices in excess of ceiling rates is therefore not inconsistent with the Court's simultaneous holding in Texaco that an entire rate cannot be based solely on market prices. The Commission's reliance on *Texaco* is therefore misplaced. This case is governed by *Mobil Oil.* The Commission's determination that it has no authority to grant individualized relief on the basis of royalty costs based on prices in excess of ceiling rates is contrary to *Mobil Oil.*

In view of the *Mobil Oil* holding, the Commission's action in this case creates the precise result the Commission recently deemed to be ludicrous in *Gulf Oil Corp.* and *Texas Eastern Transmission Corp.,* Docket No. CI64-26 (Order issued Jan. 22, 1975). In that case, the Commission had allowed a party to intervene, but Texas Eastern asserted that the Judge nonetheless had power to restrict the intervenor's participation to the point where it would be meaningless. The Commission rejected this contention:

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> "It would be small solace for a person to get the 'good news' from the Commission that it has been admitted as a party to a proceeding, only to be faced with the 'bad news' from the Judge that it cannot participate." Mimeo at 3.

Likewise, in this case it is small solace for Producing to get the "good news" from the Supreme Court in *Mobil Oil* that it can seek individualized relief, only to be faced with the "bad news" from the Commission that the Commission has no authority to grant such relief. The Commission's undue restriction of its authority is error.

In fact, the Commission has previously exercised the authority it denies itself in this case. In *American Petrofina Company of Texas (Operator), et al.*[2] the Commission granted a price increase above the ceiling rate to reflect the exact incremental costs of compression. In setting the area ceiling price involved in *American Petrofina,* the Commission had previously considered whether compression costs should be included, and, if so, the just and reasonable amount of such costs. The price increase authorized in *American Petrofina* therefore was based on an actual market cost in excess of that which the Commission had previously deemed to be just and reasonable.[3]

> "Because *American Petrofina* is currently charging the applicable area ceiling rate, its rate is just and reasonable without inquiry into its actual total costs of production. An increase in a just and reasonable rate to reflect the exact incremental costs per Mcf of compression expenses should not, of itself, deprive that rate of its just and reasonable character." *American Petrofina, supra* at 4.

American Petrofina therefore clearly establishes that the Commission has authority to permit flow through of an incremental cost which is based on the money required in

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[2] Docket Nos. RI75-17 and RI75-19 (Order issued March 3, 1975).

[3] The Commission has reached an identical result in numerous compression cases: *See Pioneer Production Corp.*, Docket No. CI73-617 (Order issued November 21, 1975) and cases cited therein at footnote 2; *Sohio Petroleum Co.*, Docket No. RI76-47 (Order issued Feb. 9, 1976).

the market place for compression. And *American Petrofina* also establishes the standard to be used in determining

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whether such flow through should be allowed.

This case is no different. Indeed the Commission has already determined that the standard set forth in *American Petrofina* is applicable here. And there is no basis for the Commission's conclusion that it has no authority to allow the flow through here even though it exercised such authority in *American Petrofina.* To the contrary, the Commission's authority is precisely the same in both cases. The Commission does not regulate the price upon which either compression expenses or royalty payments must be made, but in regulating the price of gas that is subject to its jurisdiction the Commission has determined what it deems to be a just and reasonable price, whether cost components for compression and royalty should be included in that price and, if so, the just and reasonable amount of those cost components. This previous determination was no barrier to allowing flow through of the actual market price of compression in *American Petrofina.* Likewise, the fact that the actual price that must be paid for royalties must be based on a price in excess of the just and reasonable price the Commission has set for sales subject to its jurisdiction does not preclude the price increase here. The Commission cannot legally, or equitably, treat some producers one way and Producing another.

In addition to the compression cases, the Commission's action in *El Paso Natural Gas Company*[4] is also inconsistent with its determination in this case that incremental market value royalty costs are necessarily unjust and reasonable. In the *El Paso* case, the Commission has author-

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[4] Docket No. RP74-22, *et al.* (Order issued Nov. 29, 1974), reh'g denied (Jan. 29, 1975).

ized El Paso to increase its rates, subject to refund, to allow recovery of increased overriding royalties based on market value payments being made by El Paso pursuant to an agreement made in settlement of a controversy with the overriding royalty owners. These payments are being made, and the costs recovered by El Paso, despite the fact that the royalty is based on prices in excess of Commission ceiling prices.

Yet the Commission did not determine there, as it has here, that such costs are necessarily unjust and unreasonable. If such a determination had been made, the

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increases based on the market value royalty costs would have been summarily rejected as being outside the Commission's authority.[5] Instead, the issue of the justness and reasonableness of such costs was set for hearing. The justness and reasonableness of the price increase based on incremental market value royalty costs must also be considered in this case.

In sum, the Courts have made clear that the Commission does have authority to allow a price increase to reflect increased royalty costs based on prices in excess of ceiling rates. In addition, the Commission has consistently allowed price increases to reflect exact incremental increased costs even though such costs are in excess of those previously deemed to be just and reasonable under the ceiling rate. And, in fact, the Commission has previously determined in *El Paso* that excess royalty costs based on prices above ceiling prices are not unjust and unreasonable as a matter of law.

[5] See *United Gas Pipe Line Company*, Docket No. RP75-109 (Order issued July 7, 1975), reh'g denied (Sept. 3, 1975); *United Gas Pipe Line Company*, Docket No. RP75-30 (Order issued September 4, 1975), reh'g denied (Oct. 22, 1975).

Indeed, any other result would be untenable. Under the Commission's holding in this case, costs would be unreasonable even though such costs (1) were prudently incurred (2) were absolutely essential in order to avoid lease termination or even higher costs which would reduce the funds available for exploration and development and (3) the price increase resulting from such costs would not generate a single penny of profit for the producer. There is nothing in either the Natural Gas Act or the courts' construction of that Act which requires a result so manifestly contrary to the public interest.

2. The Price Increase Is Just and Reasonable.

Since the Commission determined it was precluded as a matter of law from granting the royalty flow-through, the Commission did not address the factual question whether that price increase is just and reasonable. The Commission did set the standard by which the question must be judged, however. That standard is whether the "*incremental royalty cost* is just and reasonable."[6]

In *American Petrofina,* the Commission established the factors relevant to a determination of the justness and

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reasonableness of an exact incremental cost. The costs in that case were for compression and in finding those costs to be just and reasonable, the Commission first determined that the price increase based on such costs would not increase the producer's profit. The Commission then concluded that the price increase based on those costs was justified because it was a reasonable price to pay for the benefits achieved.

In this case, there can be no dispute as to the profit question. Every penny of the price increase will flow directly

[6] Mimeo at 6 (emphasis in original).

through to Williams. The price increase cannot possibly generate any profit for Producing.

The record is equally clear that the price increase is a more than reasonable price to pay for the benefits achieved. This question was discussed at length in Producing's Brief on Exceptions. Basically, the price increase is justified because the Williams litigation involves substantial risks for gas consumers and those risks can be eliminated by settlement only if the price increase is approved. The Commission is certainly all too well aware that as a result of cases such as *J. M. Huber Corp.* v. *Denman,* 367 F.2d 105 (5th Cir. 1967) and *Mobil Oil Corp.* v. *FPC,* 463 F.2d 256 (D.C. Cir. 1971), *cert. denied* 406 U.S. 976 (1972), market value royalty litigation presents serious problems for both the producers this Commission regulates and the gas consumers whose interests the Commission is charged with protecting. Noone has denied that the outcome of the Williams litigation is unpredictable or that an adverse resolution of the litigation carries with it substantial risks to gas consumers. These risks are:

(1) In the event the lease were terminated, diversion of all of the gas from the interstate market so that the interstate consumer cannot obtain it at any price.[7]

(2) A price increase of at least 27¢ per Mcf if the lease were terminated and Williams sells the gas in interstate commerce at the small producer national rate.

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(3) Either a price increase far in excess of that sought here if the lease is not terminated but royalty payments must be based on $1.40, or diversion to the lessor of substantial amounts of capital otherwise available for exploration and development.

[7] Whether the gas could be diverted from the interstate market if the lease were terminated is an open question which will be resolved in *Southland Royalty Co.* v. *FPC,* No. 75-2851, presently pending before the United States Court of Appeals for the Fifth Circuit.

The risks are therefore clear and the record is equally clear that the price increase which will avoid these risks will be about 3.64¢ per Mcf.[8] Whether 3.6¢ is a reasonable price to pay to avoid the adverse results otherwise possible is certainly a matter of judgment, but that judgment must be based on the record. Producing, Shell, and United all presented testimony that the price increase is reasonable and necessary to end the Williams litigation. At the same time, not a single one of United's customers, who will ultimately pay the price increase contemplated by Producing's application or bear the burden of an adverse resolution of the underlying legal issues, has expressed the slightest opposition to Producing's application. The amount of the increase is reasonable and the public interest demands that it be approved.

One final factor that may bear on the justness and reasonableness of the incremental royalty cost deserves comment in view of the Commission's statement that "if a producer desires to compute royalty payments based on a rate in excess of our applicable just and reasonable rate, he may unilaterally do so."[9] To the extent this implies that Producing was imprudent in entering into the market value lease in 1934 or intentionally and knowingly undertook to pay royalty based on prices in excess of ceiling rates, the implication is erroneous. No one has contended that the costs involved were imprudently incurred and indeed the facts show just the opposite. The lease was entered before the Natural Gas Act was even passed, twenty years before

[8] Exhibit 13.

[9] Mimeo at 6.

it was determined that the act covered producer sales,[10] and thirty-seven years before it was determined that the Act did not cover royalty owners.[11] At the risk of understatement, it would have been an unusually omniscient unregulated producer who would have foreseen that the law would develop in a manner that would require that producer to pay royalty on the basis of unregulated rates while at

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the same time sell the same gas at one-third of those rates. The market value royalty costs in this case were prudently incurred and should be reflected in Producing's rates.

B. The Commission Erred In Stating In Dicta That Excess Royalty Costs Incurred As a Result of a Court Judgment May Not Be Recovered In Producer Rates.

This case involves increased costs based on a settlement of market value royalty litigation. It does not involve costs based on a court judgment. Nonetheless the Commission stated in its Opinion in this case that incremental market value royalty costs resulting from a court judgment cannot be reflected in a producer's rate.

The Commission does, of course, have authority to reflect in jurisdictional rates costs resulting from damages assessed by a court. *Cities Service Gas Co.,* Docket No. RP 71-106 (1973 Phase) (Order issued Sept. 5, 1974). Furthermore, as discussed above, the Commission also has authority to reflect in producers' rates costs resulting from the payment of royalties based on price in excess of ceiling rates. Therefore, the Commission's statement relating to court judgments, which is mere dicta, is erroneous for all

[10] *Phillips Petroleum Co.* v. *Wisconsin,* 347 U.S. 672 (1954).

[11] *Mobil Oil Corp.* v. *FPC,* 463 F.2d 256 (D.C. Cir. 1971), *cert. denied,* 405 U.S. 1074 (1972).

the reasons set forth above relating to the price increase based on the incremental royalty costs that are involved in this case. Indeed, the dicta exposes the flaw in the Commission's reasoning since under the dicta flowing from that reasoning the Commission has concluded that prudently incurred incremental royalty costs may not be reflected in producer rates even if such costs render those rates confiscatory.

But even if the Commission determines that it has no authority to allow the royalty flow through based on the settlement involved in this case, the dicta concerning royalties based on court judgments must be eliminated from the Commission's opinion. There may be any number of factors bearing on the propriety of price increases based on court judgments which are not pertinent to the issues in this case. Whether there are any such factors and, if so, what they may be cannot be determined on the basis of the record in this case, however, for the simple reason that the court judgment issue was not involved, was not briefed by the parties, and no evidence bearing on that extraneous issue is in the record. The statement is therefore unsubstantiated, unnecessary, and can only serve to prejudice the rights of parties who may appear before the Commission in the future. Accordingly, Producing respectfully requests that the statement be eliminated from the Opinion so that the issue may be decided in the proper context in the event it is ever presented.

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C. The Commission Erred In Denying The Alternative Abandonment Request.

While Producing believes the royalty flow through is the preferable means for avoiding the risks to consumers presented by the Williams litigation, Producing also believes that the alternative abandonment proposal is far more con-

sistent with the public interest than encountering those risks. The Commission's sole reason for denying the abandonment request was that even if the litigation resulted in lease termination, the gas would still be sold in interstate commerce by Williams. If that did occur, the service which was voluntarily undertaken by Producing and Shell and is now being performed by experienced producers would be rendered on an involuntary basis by a royalty owner inexperienced in gas exploration, development, and production activities. As is expressly recognized in Section 7(e) of the Act, the public interest can be adequately served only by those "able and willing to do the acts and perform the service proposed." The public interest would therefore be disserved by the substitution of Williams for Producing and Shell.

Furthermore, as discussed above, whether dedication survives lease termination, while settled by the Commission,[12] is an open question on appeal. Undeniably, the Commission's tasks under the Natural Gas Act involve difficult questions. As a result, and also undeniably, the Commission is sometimes deemed to have decided those difficult questions incorrectly. In view of the fact that the Commission found it necessary to overrule its own prior precedent in determining that gas remains dedicated even after lease termination,[13] that question would seem to be a particularly close and difficult one. Producing submits that the public interest is better served by allowing abandonment of a fraction of the gas than by running the risk of losing it all.

D. The Commission Erred in Denying The Surcharge Request.

[12] *El Paso Natural Gas Co.*, Opinion No. 737, Docket No. CP75-209 (July 11, 1975), *reh'g denied*, Opinion No. 737-A (Sept. 3, 1975).

[13] *El Paso* v. *Bass*, Opinion No. 638, 48 FPC 1269 (1972) was overruled in Opinion No. 737-A at 3.

The surcharge request was denied for the same reasons the royalty flow through request was denied. For the reasons discussed above in connection with the royalty flow through request, the Commission erred in denying the surcharge.

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IV.

CONCLUSION

The market value royalty problem has now been brought full circle. As a result of a combination of Court decisions, producers face the prospect of having to base royalty payments on unregulated intrastate prices while at the same time being required to charge a regulated rate less than one-third that amount for the sale of the same gas upon which such payments must be made. The possibility of this totally unreasonable and unconscionable result has been recognized for many years, and the courts have assured producers that individualized relief would be available in the event those fears were realized. The problem has now been realized, but the Commission has now said the courts' assurances cannot be fulfilled because the Commission has no authority to do so. The Commission's expression of sympathy for producers caught in this bind is understandable.

Fortunately, the Commission need not put itself in a position where it feels compelled to offer sympathy to those companies it regulates. For there is nothing in the Gas Act or the cases construing that Act which requires the result the Commission has reached. To the contrary, *Mobil Oil* precludes that result and the Commission's own previous action are inconsistent with it. The issue, therefore, is and must be whether, considering *all* the relevant factors, the price increase Producing seeks is just and reasonable.

On that issue the record is clear. Of primary importance, the record establishes that the price increase is consistent with the basic purpose of the Gas Act because it cannot possibly result in "excess profits." Furthermore, the increase is based on a cost that was prudently incurred and is an absolutely essential expense in order to avoid the substantial risks of the Williams litigation. Producing respectfully submits that the Commission erred in holding that a price increase that is so demonstrably just and reasonably must nonetheless be rejected as a matter of law.

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Therefore, Producing requests that the Commission grant rehearing of its Opinion No. 753 issued in this case, and grant Producing's price increase and surcharge requests. In the alternative, Producing requests that the abandonment alternative be approved. In addition, in view of the time constraints involved, Producing respectfully requests the Commission to act expeditiously on this petition.

Respectfully submitted,

Stephen M. Hackerman

A. Duncan Gray, Jr.
Vice President and
General Attorney

Diane Barber
Pennzoil Producing
Company
900 Southwest Tower
Houston, Texas 77002

Jeron Stevens
Stephen M. Hackerman
3000 One Shell Plaza
Houston, Texas 77002

Bruce F. Kiely
Suite 300
1701 Pennsylvania
Ave., N.W.
Washington, D.C. 20006

Baker & Botts
3000 One Shell Plaza
Houston, Texas 77002
Attorneys for Pennzoil
Producing Company

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Pennzoil Producing Company
DOCKET NO. RI76-8

Shell Oil Company
DOCKET NO. RI76-10

APPLICATION FOR REHEARING

Comes now Shell Oil Company and applies for rehearing of the Commission's Opinion No. 753 in the captioned proceeding, pursuant to Section 1.34 of the Commission's Rules of Practice and Procedure (18 C.F.R. 1.34) and Section 19(a) of the Natural Gas Act (15 U.S.C. § 717r). In accordance with the aforesaid Section of the Commission's Rules, the following specifications of error are noted:

SPECIFICATIONS OF ERROR

1. The Commission has erred by failing to permit the implementation of a Settlement Agreement between Shell and Williams, Inc., which would resolve the pending litigation in the State Court of Orleans Parish, Louisiana. This Settlement could have been effectuated, either by the approval of an abandonment of the lessor's proportionate interest in the gas stream, or by permitting Shell to "flow through" the additional royalty payable to the lessor based on the royalty percentage being calculated on a price of 78 cents per Mcf. By refusing to grant either of these alternatives, neither of which would have resulted in any monetary advantage to Shell, the Commission has abused its discretion and committed a legal error.

2. In failing to consider the possibility that its adverse decision may result in a partial loss of the gas supply to United Gas Pipe Line Company, which is already

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under severe curtailment, the Commission has failed to consider the "end result" of its decision and its impact of its decision on the consumer, and has therefore committed legal error.

3. In failing to consider the fact that, if Williams, Inc. prevails in the lawsuit in Orleans Parish, Louisiana with the result that Shell's leases are cancelled, or are made uneconomic to continue an operation because the royalty payments will exceed the total revenues to be received from the leases, in which event, cost to the consumer will increase more than the flow through of the rate requested here, the Commission has failed to consider the end result of its decision on the consumer, and has therefore committed legal error.

4. In establishing the area ceiling rate applicable to a portion of the gas being sold here, the Commission based its ceiling rates on a cost calculation utilizing a royalty cost of 15 percent of gross revenue received from the lease (*Southern Louisiana Area Rate Decision II,* 46 F.P.C. 86, at 132). In determining the national ceiling rate for new gas, which is applicable to the remainder of the gas involved in this proceeding, the Commission based its ceiling rate on a unit cost calculation which utilized a royalty percentage of 16 percent of gross revenue, see *National Rate Cases For New Gas,* Docket No. R-389-B, Opinion No. 699, 51 F.P.C. 2212, at 2272. The uncontested record in this proceeding shows that Shell may be required, if Williams, Inc. prevails in the State Court lawsuit to pay royalty rates which are greatly in excess of those utilized by the Commission in determining the area and national ceiling rates. The Commission has erred in refusing to permit the adjustment of Shell's rates to reflect these increased costs.

5. The Commission has erred in failing to allow special relief, which it had indicated to the United States Court of Appeals for the Fifth Circuit would be allowed, in situations where the royalty obligations under the lease placed the producers "in a bind" through no fault of their own, see *Placid Oil Co.* v. *F.P.C.,* 483 F.2d 880, at 911.

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6. The Commission has erred in requiring project costs (referred to in the record as "overall costs") for the particular leases in question before considering whether to permit special relief to compensate producers for excess royalty costs which are over and above those costs contemplated in the area and national rate proceedings fixing the ceiling rate covering the area here in question. A requirement to utilize "project" costs is a basic change in producer regulation, and represents an abandonment of the theory of area ratemaking affirmed by the Supreme Court in the *Permian Basin Area Rate Cases,* 390 U.S. 747 (1968) and *Mobil Oil Corp.* v. *F.P.C.,* 417 U.S. 283 (1974), and thereby represents unlawful discrimination against Shell Oil Company in a manner prohibited by Section 4(b) and Section 5(b) of the Natural Gas Act (15 U.S.C.A. 717(c)(d).

7. In denying Shell's request for special relief unless Shell was able to submit project cost data which was physically impossible to compile within the time limit permitted by the Commission, the Commission has imposed rates upon Shell which may be confiscatory without granting Shell the opportunity to present evidence in support of those rates, and has therefore denied Shell due process of law as provided by the Administrative Procedure Act and the United States Constitution.

8. By providing in the area and national rate proceedings that producers were not entitled to any consideration in the area or national rate because of royalty clauses in oil

and gas leases which might permit the collection of royalty based on the market value of the gas, instead of the Commission's determined rate, and finding that those such problems should be dealt with in actions for special relief by the producer, and in turn by providing in actions for special relief from the same problem by producers the Commission was not authorized to grant such relief where the royalty was based on something more than the just and reasonable rate (Opinion, p. 6) the Commission has effectively foreclosed any consideration of the market value royalty problem in any forum, and has therefore deprived Shell of its property without due

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process of law, by imposing a rate which may be confiscatory.

WHEREFORE, Shell Oil Company respectfully requests that the Commission grant rehearing of its Opinion No. 753, and that upon rehearing the Commission grant the special relief requested in Shell's Application.

Respectfully submitted,

Thomas G. Johnson
William G. Riddoch

Attorneys for
SHELL OIL COMPANY

By /s/ THOMAS G. JOHNSON
Thomas G. Johnson

February 12, 1976
Houston, Texas

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Pennzoil Producing Company
Docket No. RI76-8

Shell Oil Company
Docket No. RI76-10

APPLICATION FOR REHEARING

Pursuant to Section 19(a) of the Natural Gas Act and Section 1.34 of the Commission's Rules of Practice and Procedure, United Gas Pipe Line Company (United) hereby petitions the Commission for rehearing of its Opinion No. 753 issued in this proceeding on January 30, 1976. In accordance with the aforesaid Section of the Commission's Rules, the following specifications of error are noted:

SPECIFICATIONS OF ERROR

1. The Commission erred in failing to consider whether the interests of the gas consumer require the approval of either alternative contained in the settlement agreement.

2. The Commission erred in failing to consider the price at which the gas would remain in interstate commerce if Williams is successful in terminating the leases in the state court litigation. Williams may be able to qualify for the Opinion No. 699-H rate for all the gas and/or the small producer rate, both of which would be higher than the present effective rates and the rates proposed by the settlement agreement.

3. The Commission erred in failing to find that the public interest, convenience and necessity require the certainty of gas supply that would result from approval of either alternative of the settlement agreement. If the increased

royalty alternative is approved, all the gas will remain committed to United and its customers. If the abandonment alternative is approved, United and its customers would be assured of receiving at least all of the working interests share of the gas. If neither alternative of the settlement is approved, all of the gas, royalty and working interests, could be lost to the interstate market if Williams is successful in terminating the leases and Opinion No. 737, the *Southland Royalty* proceeding, is reversed on appeal.

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4. The Commission erred in holding that the price increases contained in the settlement agreement are not justified in the public interest, convenience and necessity and are not just and reasonable.

5. The Commission erred, after denying price relief, in holding that the less favored alternative of permitting abandonment of the royalty gas does not meet present or future public convenience and necessity.

WHEREFORE, United respectfully requests that the Commission grant rehearing of its Opinion No. 753, and that upon rehearing the Commission grant the relief requested in the applications filed by Pennzoil Producing Company and Shell Oil Company.

Respectfully submitted,

WILLIAM B. CASSIN
Group Vice President and
General Counsel

PHILLIP D. ENDOM
Vice President and
Associate General
Counsel

W. O. CRAIN, JR.
LEE M. HUBER
P. O. Box 1478
Houston, Texas 77001

DONALD R. ARNETT
1223 Chamber of
Commerce Building
Houston, Texas 77002

By LEE M. HUBER
Lee M. Huber

Attorneys for
United Gas Pipe Line
Company

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners:
Richard L. Dunham, Chairman;
John H. Holloman III, and James G. Watt.

PENNZOIL PRODUCING COMPANY
Docket No. RI76-8

SHELL OIL COMPANY
Docket No. RI76-10

OPINION NO. 753-A

OPINION AND ORDER DENYING REHEARING

(Issued February 27, 1976)

Pennzoil Producing Company and Shell Oil Company on February 13, 1976, and United Gas Pipe Line Company (United) on February 26, 1976, have filed applications for rehearing of the Commission's Opinion No. 753 and order issued January 30, 1976. The Opinion and order relate to gas produced by Pennzoil and Shell in the Gibson Field, Terrebonne Parish, Louisiana and sold to their customer, United Gas Pipe Line Company. The lessors in the Field, Williams, Inc. and others (Williams), had demanded higher royalties based on the market price for the gas; a civil suit in Louisiana had commenced on the applicability of the market price; and on June 18, 1975, Pennzoil, Shell and Williams had entered into a settlement agreement under which Pennzoil and Shell would apply to the Commission for authority, among other things, to pay a royalty based on a price of 78 cents per Mcf, or alternatively abandon the royalty gas to Williams. Pennzoil and Shell also agreed to pay Williams a surcharge for alleged past underpayment of royalties and proposed to flow through the increased royalties and the surcharge to United.

In its Opinion No. 753 and order the Commission, in adopting the initial decision of the Administrative Law Judge, denied the special relief, the surcharge and the abandonment. Pennzoil and Shell contend that the Commission is in error and, Pennzoil states that, while the settlement agreement was subject to cancellation by February 1, 1976, Williams has agreed that the settlement will not be cancelled before March 1, 1976.

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In the first place Pennzoil contends that the Commission has authority to allow increased rates to reflect royalty payments based on prices in excess of ceiling rates. The Commission said that it was not free to allow royalty costs, which are based on market values, to be passed on to the pipeline as just and reasonable rates. Pennzoil cites *Placid Oil Co.* v. *F.P.C.*, 483 F.2d 880 (CA5, 1973), where the Court said that if producers are put in a bind by their royalty obligations they may petition the F.P.C. for individualized relief, and *Mobil Oil Corp.* v. *F.P.C.*, 417 U.S. 283 (1974), affirming *Placid* and saying that a producer affected by higher royalty obligations is entitled to seek individualized relief. While indicating that relief on some grounds may be possible, this case does not state under what conditions relief should be granted, nor does it define when the right to gain relief matures.

In *F.P.C.* v. *Texaco Inc.*, 417 U.S. 380 (1974), the Commission was instructed to insure "that the rates paid by pipelines, and ultimately borne by the consumers, are just and reasonable" and that "the prevailing price in the market place cannot be the final measure of just and reasonable rates mandated by the Act." While Pennzoil argues here that the price increase is based on a number

of factors, including the risks of the Williams litigation, the propriety of the settlement, and the fact that it is not based on the full market price, it is plain that the royalty is to be based on 78 cents, which is the settlement's reflection of market prices, that are above the area ceiling prices.

The area ceiling prices are intended to be just and reasonable rates. The Commission was upheld in determining just and reasonable rates for the Southern Louisiana area in *Mobil, supra.* The Commission determined just and reasonable national rates in Opinions Nos. 699 and 699-H and was affirmed on appeal.[1] In arriving at the national rates costs of

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production were used and royalties were computed at 16 percent of total costs. (51 FPC at pp. 2272-2273) It is for these reasons that the Commission is not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates.

Pennzoil argues that it is an entirely different question when we are dealing with an incremental price that does not generate excessive profits, but *Texaco* says that "a little unlawfulness" is not permitted. In this connection *American Petrofina Company of Texas (Operator), et al.,* FPC, Docket Nos. RI75-17 and RI75-19, issued March 3, 1975, is not in point. In that case the company was given relief because of the costs of additional necessary compression. There was no question of the reasonableness of compression costs or whether they were determined on the basis of lower interstate prices or higher intrastate prices. Nor are the *El Paso Natural Gas Company,* FPC , Docket

[1] *Just and Reasonable National Rates for Sales of Natural Gas from Wells Commenced on or after January 1, 1973,* Opinion No. 699, 51 FPC 2212 (1974); Opinion No. 699-H, FPC , Docket No. R-389-B, issued December 4, 1974; *aff'd Sub. Nom. Shell Oil Co. v. F.P.C.,* 520 F.2d 1061 (CA5, 1975).

No. RP74-22, *et al.,* orders issued November 29, 1974, and January 29, 1975, in point. In that case the Commission had originally prevented El Paso from collecting a rate increase based on increased royalties which had not yet been paid, but in the cited orders we allowed such rate increases to go into effect subject to refund saying that El Paso had begun paying the increased royalty charges but our review raised a number of issues relating to the justness and reasonableness of the proposed rates that required further consideration by the Commission. Thus in *El Paso* the validity of the increased charges based on royalties was not determined.

Pennzoil further argues that the price increase is just and reasonable, pointing out the risks of the Williams litigation and contending that the gas may be diverted from the interstate market. Pennzoil also notes that no one has contended that the costs involved were improvidently occurred. These considerations are not controlling. The Commission does not have the power to base a part of the regulated price on the unregulated market value of intrastate gas. Pennzoil also objects to the statement that the Commission cannot permit incremental royalty costs resulting from any judgment by a state court from being passed on to a pipeline if the incremental costs are based on any other factors than

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the regulated just and reasonable rate. Pennzoil says that this is dicta and it should be eliminated. Since there is no state court judgment and it is indeed dicta, it will not be necessary to discuss it further at this time. Pennzoil's arguments on the issues of abandonment and surcharge are sufficiently covered in the original opinion, and need not be addressed again.

Shell has listed specifications of error that relate to the discussion of the Administrative Law Judge as well as to our discussion in Opinion No. 753. These matters have largely been covered. Shell contends, *inter alia,* that we have not considered the end result of our decision on the consumer, saying that the gas supply may be lost. The gas supply here that is dedicated to interstate commerce cannot be diverted to intrastate commerce. At the same time, if royalty costs could be based on higher intrastate market values, the impact on the consumer could extend far beyond this case. It is not in the public interest that national rates be distorted in the manner contemplated by Shell, which would create a new species of interstate gas which would rise and fall with intrastate market values.

Also Shell says that the Commission has foreclosed any consideration of the market value royalty problem in any forum and has therefore deprived Shell of its property without due process of law. In this proceeding a hearing was held; the Presiding Judge issued an initial decision to which exceptions were taken; and the Commission considered the issues on the basis of the record. There is no dispute whatever about the facts relating to the computation of the proposed rates based upon market value royalties. Pennzoil, Shell and United have expressed their views, and the Commission determined that special relief should not be granted on the basis of market value royalties. United's contentions are covered by Opinion No. 753 and this Opinion.

The Commission further finds:

The assignments of error and grounds for rehearing of Opinion No. 753 and order in the applications for rehearing filed by Pennzoil, Shell, and United present no facts or legal principles that would warrant any change in or modification of the Commission's Opinion No. 753 and order as supplemented by the above discussion.

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The Commission orders:

The applications for rehearing filed by Pennzoil and Shell on February 13, 1976, and United on February 26, 1976, are denied.

By the Commission.

(SEAL)

KENNETH F. PLUMB,
Secretary.

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners:
Richard L. Dunham, Chairman;
Don S. Smith, John H. Holloman III,
and James G. Watt.

PENNZOIL PRODUCING COMPANY
Docket No. RI76-8

SHELL OIL COMPANY
Docket No .RI76-10

OPINION NO. 753-B

OPINION AND ORDER DENYING REHEARING AND GRANTING INTERVENTION

(Issued March 26, 1976)

Northwest Pipeline Corporation (Northwest) on February 26, 1976 filed an application for rehearing with respect to the Commission's Opinion No. 753 and order issued January 30, 1976, and on February 27, 1976, filed a petition for leave to intervene. The State of Louisiana on March 1, 1976, also filed an application for rehearing. The nature of this proceeding is described in Opinion No. 753 and Opinion No. 753-A issued February 27, 1976, where the Commission denied applications for rehearing filed by Pennzoil Producing Company, Shell Oil Company and United Gas Pipe Line Company (United). Briefly the lessors in the Gibson Field, Terrebonne Parish, Louisiana, Williams, Inc. and others (Williams) have demanded higher royalties from Pennzoil and Shell based on the market price for the gas, and Pennzoil and Shell, in accordance with a settlement agreement, propose to pass the cost of these royalties on to their customer, United, or alternately abandon the royalty gas to Williams.

Northwest says that it is required to file its petition for leave to intervene as well as its application for rehearing in order to assure that no action is taken by the Commission in these dockets which would prejudice it in *El Paso Natural Gas Co. and Northwest Pipeline Corp.*, Docket No. RP74-23 and *Northwest Pipeline Corp.*, Docket No. RP74-95, or before the Courts in related litigation in *El Paso Natural Gas Co.* v. *Mobil Oil Corp.*, Nos. MO-74-CA-57 (U.S.D.C.W.D. Tex.) where Northwest is a party plaintiff.

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Northwest is concerned with the language of the Commission in Opinion No. 753 that it "cannot permit any incremental royalty costs resulting from this settlement, or resulting from any judgment by a state court regarding royalty payments, to be passed on to the pipeline if these incremental royalty costs are based on any other factors than the regulated just and reasonable rate." As the Commission said, the language insofar as it relates to a court judgment is dicta and it will not be necessary to discuss it further. The Commission however, recognizes Northwest's interest in the proceeding because of its relation to events on its own system and deems it appropriate to grant it intervention.

Louisiana argues that while producer rates under the Natural Gas Act must be just and reasonable, the question is not what a cost should be based on but rather whether the cost incurred was prudent and reasonable when incurred. This matter is covered by our discussion in Opinion Nos. 753 and 753-A. It may be observed that Louisiana quotes *Placid Oil Co.* v. *F.P.C.*, 483 F.2d 880, 911 (CA5-1973), aff'd sub nom *Mobil Oil Corp.* v. *F.P.C.*, 417 U.S. 283 (1974):

> Of course the royalty obligations of the producers are cost components of the rate structure. Any alteration

of this component would necessarily alter the departure point of the rate calculations.

The Court further stated that under *Mobil*[1] this would be a determination of the contract stating the royalty percentage based upon the applicable principles of state law — totally beyond F.P.C. control. The Court, however, added:

> "But we are not willing to alter or stay the implementation of area wide rates for the entire industry merely on the basis of what might happen to some producers' costs if this statement of the law prevails."

It is plain that an allowance for a royalty in an area rate would depend on the royalties generally being paid in the area. This does not mean, however, that an individual producer's rate should be increased because it must pay a higher royalty, particularly one based on market value.

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The Commission further finds:

(1) The assignments of error and grounds for rehearing of Opinion No. 753 and order set forth in the applications for rehearing filed by Northwest and Louisiana present no facts or legal principles that would warrant any change in or modification of the Commission's Opinion No. 753 and order as supplemented by Opinion No. 753-A and this opinion.

(2) It may be in the public interest to allow Northwest to intervene in these proceedings.

The Commission orders:

(A) The applications for rehearing filed by Northwest and Louisiana are denied.

[1] *Mobil Oil Corp.* v. *F.P.C.*, 463 F.2d 256 (CADC-1972); certiorari denied, 406 U.S. 976 (1971).

(B) Northwest is permitted to intervene in the above proceedings subject to the rules and regulations of the Commission: *Provided, however,* that the participation of such intervenor shall be limited to matters affecting asserted rights and interests as specifically set forth in its petition for leave to intervene and that said intervenor take the record as it finds it, and *Provided, further,* that the admission of such intervener shall not be construed as recognition by the Commission that it might be aggrieved because of any order or orders of the Commission entered in these proceedings.

By the Commission.

KENNETH F. PLUMB,
Secretary

(SEAL)

In the United States Court of Appeals for the Fifth Circuit

(Title omitted in printing)

Reference to the Opinion of the Court of Appeals for the Fifth Circuit

(Dated June 6, 1977)

The Opinion of the Court of Appeals for the Fifth Circuit in this case, 553 F. 2d 485 (C.A. 5 1977), has been reproduced as Appendix A in the Petition for a Writ of Certiorari No. 77-648, *Federal Energy Regulatory Commission* v. *Pennzoil Producing Co., et al.*

In the United States Court of Appeals for the Fifth Circuit

(Title omitted in printing)

Reference to the Judgment of the Court of Appeals for the Fifth Circuit

(Dated June 6, 1977)

The Judgment of the Court of Appeals for the Fifth Circuit has been reproduced as Appendix B in the Petition for a Writ of Certiorari No. 77-648, *Federal Energy Regulatory Commission* v. *Pennzoil Producing Co., et al.*

In the United States Court of Appeals for the Fifth Circuit

(Title omitted in printing)

Reference to the Order on Rehearing of the Court of Appeals for the Fifth Circuit

(Dated September 1, 1977)

The Order on Rehearing of the Court of Appeals for the Fifth Circuit, 558 F. 2d 816 (C.A. 5 1977), has been reproduced as Appendix C in the Petition for a Writ of Certiorari No. 77–648, *Federal Energy Regulatory Commission* v. *Pennzoil Producing Co., et al.*

In the Supreme Court of the United States

No. 77–648

FEDERAL ENERGY REGULATORY COMMISSION, PETITIONER

v.

PENNZOIL PRODUCING COMPANY, ET AL.

Order Allowing Certiorari. Filed June 12, 1978

The petition for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit is granted.

Mr. Justice Stewart and Mr. Justice Powell took no part in the consideration or decision of this petition.

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IN THE

Supreme Court of The United States

OCTOBER TERM, 1977

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION,

Petitioner,

v.

PENNZOIL PRODUCING COMPANY, ET AL.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF OF RESPONDENT PENNZOIL PRODUCING COMPANY IN OPPOSITION

A. DUNCAN GRAY, JR.
Vice President and
General Attorney
Pennzoil Producing Company
3100 Pennzoil Place
Houston, Texas 77001

JERON STEVENS
STEPHEN M. HACKERMAN
Baker & Botts
3000 One Shell Plaza
Houston, Texas 77002
(713) 229-1234

Counsel For Respondent
Pennzoil Producing Company

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IN THE

Supreme Court of The United States

OCTOBER TERM, 1977

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION,

Petitioner,

v.

PENNZOIL PRODUCING COMPANY, ET AL.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF OF RESPONDENT PENNZOIL PRODUCING COMPANY IN OPPOSITION

OPINIONS BELOW AND JURISDICTION

The opinions below are correctly referenced and the jurisdictional prerequisites are adequately set forth in the petition for a writ of certiorari.

QUESTION PRESENTED

Whether the Federal Energy Regulatory Commission (Commission) has the authority to adjust the rate charged

for the sale of natural gas by an independent gas producer to allow recovery of prudently incurred increased royalty costs based on prices in excess of Commission established ceiling rates.

STATUTES INVOLVED

Section 4(a) of the Natural Gas Act, 15 U.S.C. 717c(a), is correctly set forth in the petition for a writ of certiorari.

STATEMENT OF THE CASE

Pennzoil Producing Company (Pennzoil Producing) sells to United Gas Pipe Line Company gas produced from acreage in the Gibson Field, Terrebonne Parish, Louisiana, a portion of which is leased from Williams, Inc., *et al.* (Williams). Because the sale is in interstate commerce for resale, the price which Pennzoil Producing may collect is subject to the jurisdiction of the Commission and is limited to the applicable ceiling rates established by the Commission.[1] The amount that Williams, as lessor, receives from Pennzoil Producing in payment of royalties under the lease covering the acreage from which the gas is produced is not, however, subject to the Commission's jurisdiction. *Mobil Oil Corp.* v. *FPC,* 463 F.2d 256 (D.C. Cir. 1971), *cert. denied,* 406 U.S. 976 (1972).

The Williams lease provides for royalty payments based on one-eighth of the "market rate" of the gas. Pennzoil Producing is collecting the highest rates allowed by the Commission for the sale of the Williams acreage gas and is paying royalty based on such rates.[2] Williams claims, however, that the "market rate" for the gas is in excess of that which the Commission has determined to be the highest rate

[1] Natural Gas Act, Sections 1(b) and 4(a), 15 U.S.C. §§ 717(b) and 717c(a).

[2] A portion of the gas is covered by the rate set forth in 18 C.F.R. § 2.56b, adopted in FPC Opinion No. 749, and the rest is covered by the rate set forth in 18 C.F.R. § 2.56a, adopted in FPC Opinion Nos. 699-H and 770-A.

which Pennzoil Producing can collect. In a lawsuit pending in a Louisiana state court, Williams claims damages in excess of $3,000,000 for alleged past underpayment of royalties through April 20, 1975.[3] In addition, Williams asserts that the lease has terminated as a result of the alleged underpayment of royalties.

The parties to the Louisiana state court litigation reached a settlement agreement on June 18, 1975. Implementation of the agreement is dependent upon Commission authorization of one of two alternatives set forth in the agreement. First, the Williams litigation would be settled if the Commission authorized Pennzoil Producing to increase its rates for gas sold from the Gibson Field in an amount that would allow recovery of the increase in royalty payments that would be made under the settlement agreement. The royalty basis under the settlement agreement is a compromise figure. It is an amount in excess of the ceiling rates which Pennzoil believes to be the proper royalty basis, but less than the alleged market rate Williams asserts is the appropriate royalty basis. Contrary to the Commission's assertion that the settlement royalty basis is based on "market value," it is tied directly to Commission-set rates because it is a percentage of those rates and will change only as the rates set by the Commission change.[4] Thus the royalty

[3] *Shell Oil Co. and Pennzoil Producing Co.* v. *Williams Inc., et al.,* Civil District Court for Orleans Parish, Louisiana, Docket No. 573-591 (filed May 24, 1974). Shell Oil Company also owns an interest in the lease involved as well as an interest in another lease of which Williams is the lessor. Shell therefore is both a party to the Louisiana state court litigation and a respondent in this case.

[4] The royalty basis specified in the agreement is an amount equal to (1) the higher of 78¢ (plus 1.5¢ per Mcf annual escalations commencing January 1, 1976) or 150% of the highest area or national rate authorized by the Commission, plus (2) BTU and tax adjustment. The 78¢ was 150% of the then effective Commission-set national rate. The 150% figure was the same as that proposed by the Commission for small producers such as Williams appeared to be. Since the time this royalty basis was agreed upon, the Commission has adopted a new highest ceiling rate

increment will not, as the Commission suggests (Pet. 15), fluctuate along with intrastate prices — that simply is not a possibility raised by this case. Under the second alternative, the litigation would be settled if the Commission authorized Pennzoil Producing to abandon the sale of the royalty share of the gas so that Williams could take its royalty share in kind.

By its application below, Pennoil Producing sought the requisite Commission authorization. Because the price increase is totally based on increased royalty costs and will therefore generate absolutely no profit for Pennzoil Producing, and because this cost is a prudent and necessary expense, Pennzoil Producing believes the price increase to be just and reasonable. The Commission, however, rejected the price increase despite the evidentiary record showing it to be just and reasonable and in the public interest. Although "sympathetic to the plight of the producers who face . . . litigation on the value of royalties," the Commission nonetheless felt compelled to ignore the facts of record because of its view that, no matter whether prudently incurred and otherwise just and reasonable or not, the Commission is without authority to reflect in producer rates royalty costs based on prices in excess of ceiling rates.

which became effective July 27, 1976. FPC Opin. No. 770-A (Nov. 5, 1976), *aff'd., The Second National Natural Gas Rate Cases,* F.2d (D.C. Cir. 1977), *petition for cert. filed,* U.S.L.W. (U.S. Nov. 15, 1977) (Nos. 77, 695, *et al.*). In addition, the small producer increment, which at the time the agreement was executed allowed small producers to collect 150% of the applicable ceiling rate, has been eliminated as to gas qualifying for the highest ceiling rate and set at 130% for other gas. Small Producer Regulation, Docket No. R-393, Opin. No. 742-B (Aug. 2, 1976) and Order No. 553-A (Sept. 9, 1976).

By letter of October 24, 1977, Williams agreed to modify the settlement royalty basis to take account of these changes in the Commission's pricing structure. As modified, the settlement royalty basis remains the same for gas delivered prior to July 27, 1976, but the royalty basis for gas delivered after July 26, 1976 will be the higher of (1) 78¢ as escalated or (2) 100% rather than 150% of the highest area or national rate.

The request to abandon the royalty share of the gas was presented to the Commission as an alternative to be considered only in the event the price increase request was denied. Pennzoil Producing believes the abandonment request is consistent with the public interest because, if the price increase request is denied, abandonment of the royalty share of the gas is the only means to settle the litigation and thereby eliminate the risk that all of the gas will be lost by the interstate market if Williams prevails as to lease termination. The Commission, however, denied the abandonment request based on its view, as expressed in the Commission's then unreviewed decision in the *Southland Royalty* case,[5] that the Williams acreage gas would have to be sold in interstate commerce even after termination of the Williams lease.

On appeal, the United States Court of Appeals for the Fifth Circuit determined that the Commission erred in rejecting both the alternative requests. Noting that Pennzoil Producing does not seek to increase its profits by the price increase, but instead merely seeks to recover incremental royalty costs, the Court held that the Commission has the authority to determine whether the incremental royalty cost is reasonable and, if so, to permit a price increase based on such cost. The Court viewed this Court's holding in *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283 (1974), as affirming that authority. The Commission's rejection of the alternative abandonment request was reversed and remanded for further consideration because the Commission's *Southland Royalty* decision, upon which the Commission placed total reliance in rejecting the abandonment request, was itself reversed.[6]

[5] *El Paso Natural Gas Co.*, Opin. No. 737, Docket No. CP75-209 (July 11, 1975) *reh'g. denied*, Opin. No. 737-A (Sept. 3, 1975).

[6] *Southland Royalty Co.* v. *FPC*, 543 F.2d 1134 (5th Cir. 1976), *cert. granted sub com. California* v. *Southland Royalty Co.*, 45 U.S.L.W. 3834 (June 27, 1977).

ARGUMENT

A writ of certiorari should not be granted in this case because the single question presented has already been answered by this Court. The question is whether the Commission has the authority to permit a producer to recover prudently incurred incremental royalty costs based on prices in excess of ceiling rates. This Court expressly answered that question in the affirmative in *Mobil Oil Corp.* v. *FPC,* 417 U.S. 283 (1974).

In addition to questioning its authority to consider the merits of the price increase request, the Commission in its petition also questions its authority to consider the merits of the alternative abandonment request. In fact, however, the Commission did not deny itself the authority to consider the merits of the abandonment request and thus its authority to grant that request is not an issue in this case. Consequently this case does not present any issue which justifies review by this Court.

I.

THE COMMISSION HAS THE AUTHORITY TO GRANT THE REQUESTED PRICE INCREASE

The authority to grant the price increase requested in this case is vested in the Commission by Section 4(a) of the Natural Gas Act. Under that Section, the Commission is authorized to permit a price increase so long as the increase is deemed to be "just and reasonable." The Commission now asserts that this same statute, which concededly requires it to assess the justness and reasonableness of the price increase, also denies it the authority to consider the facts bearing on that assessment. In its attempt to support this position, the Commission basically makes only two arguments. First, the Commission argues that *Mobil, supra,* merely recognizes that the Commission in fact has authority to grant relief in some instances where a cost component exceeds the Commission-established rate, but that such

recognition does not extend to royalty costs. Second, the Commission argues that *FPC* v. *Texaco,* 417 U.S. 380 (1974), prohibits approval of any rate (or component of a rate) which is equal to a market rate, regardless of any other facts or circumstances. Neither of those arguments has any basis.

As to the Commission's first argument, *Mobil* specifically addressed the issue of whether a producer faced with an incremental royalty cost may obtain relief from the Commission, and the answer was "Yes." In *Mobil,* this Court reviewed FPC Opinion No. 598 which established an area rate for Southern Louisiana. Mobil contended that the Opinion No. 598 rate was inadequate because the royalty component of the Opinion No. 598 rate was based entirely on the ceiling rate, while some producers faced the possibility of having to pay royalties on the basis of prices in excess of the ceiling rate.

In response, this Court held that the royalty component was adequate because not all producers faced the possibility of market value royalty costs and those who were subsequently put in a royalty bind could obtain relief through individualized proceedings. In so holding, this Court adopted the language that had been used by the Court of Appeals in responding to Mobil's contention:

> "If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief." 417 U.S. at 328 [quoting from *Placid Oil Corp.* v. *FPC,* 483 F.2d 880 (5th Cir. 1973)].

The Commission has attempted to deal with *Mobil,* but its attempts are successful only to show that the question presented in this case has already been answered in *Mobil.* Thus, the Commission stated on rehearing of Opinion No. 753 that *Mobil* indicates ". . . that relief on some grounds may be possible . . . ." Pennzoil Producing has no quarrel with this reading of *Mobil.* But surely if relief on some

grounds is possible, the Commission must have authority to determine whether the grounds warranting such relief are present, and, if so, to grant the relief.

In its Petition, the Commission again attempts to deal with this Court's holding in *Mobil* that "... an affected producer is entitled to seek individualized relief . . . ." The Commission suggests that this holding was a recognition of the Commission's general authority to grant relief in some cases where actual costs exceed those provided for in the ceiling rate, but was not a recognition of the Commission's authority to grant such relief if the costs involved are royalty costs based on prices in excess of ceiling rates.[7] In fact, of course, this Court's holding in *Mobil* was not simply a general statement made without reference to a particular issue. Rather, as discussed above, the Court was responding specifically to the problem posed by royalty costs based on prices in excess of ceiling rates. This is made clear by the Commission's brief to this Court in the *Mobil* case. At page 62 of that brief, the Commission evidenced full confidence in its authority to permit the relief sought by Pennzoil Producing:

> "Mobil argues . . . that the Commission improperly treated royalty payments as a fixed percentage of total costs, because some producers *may* be required to pay royalties on the basis of higher values. *The court of appeals correctly concluded that* the issue is hypothetical at this stage and that *if it becomes a reality producers may seek special relief from the Commission.*" (First emphasis in original; other emphasis added.)

The Commission is now in the position of arguing that its area rates are appropriate because if a producer is faced with a higher royalty cost that producer may seek individualized relief but the catch is the Commission lacks authority to grant such relief. This in itself demonstrates the lack

[7] Pet. 15.

of basis, and reason, underlying the Commission's petition for a writ of certiorari — such a result is absurd.

Despite the clear holding of *Mobil* affirming the Commission's authority in this case, the Commission asserts that the decision by the Court below is inconsistent with *FPC* v. *Texaco, supra.* The Commission contends that it is precluded from granting the price increase request because *Texaco* denies the Commission authority to deem a price just and reasonable solely by reference to market price.

The Commission's reliance on *Texaco* is misplaced for two reasons. First, *Texaco's* proscription against basing a just and reasonable finding solely on the fact that the price involved is equal to market price has no application to this case because the price increase involved here is not based on market price at all. As the Commission suggests,[8] market price as used in *Texaco* means the price obtained in a non-regulated market.[9] Thus, in Southern Louisiana the only prices that can possibly be classified as market prices in the *Texaco* sense are those for intrastate sales. While Williams' claim is certainly based on such intrastate prices, the royalty cost under the settlement agreement upon which the price increase request is based most assuredly is not. Rather, the royalty basis is a compromise figure substantially less than the intrastate prices which form the basis for Williams' claim. The price increase in fact is based on and tied to Commission approved ceiling rates. The Commission's statement that this case involves a price increase based on market prices is contrary to the facts.

But even if the price increase were based on market price as that phrase is used in *Texaco*, the Court's holding below would still be entirely consistent with *Texaco*. The Com-

[8] Pet. 12.

[9] Of course, in our view market price in a regulated market is the price one is permitted by the regulator to receive. Thus, "market rate" as used in the Williams lease means the prices permitted by the Commission since the Williams acreage gas is sold in a regulated market.

mission's position to the contrary is based on the erroneous premise that *Texaco* precludes the Commission from considering any facts bearing on justness and reasonableness if the price under consideration happens to coincide with market price. In fact, *Texaco* does just the opposite. It requires the Commission to consider all relevant facts bearing on justness and reasonableness by precluding the Commission from relying *solely* on the fact that a price coincides with market price.

In short, *Texaco* is simply an affirmation of the inherently factual inquiry that must be made under Section 4(a) of the Gas Act. The Commission cannot approve a rate simply because it coincides with market price. Rather, all relevant facts must be considered. By the same token, the Commission cannot reject a price simply because it coincides with market price. Again, all relevant facts must be considered.[10]

As recognized in *Texaco,* there may be any number of facts which may support a finding of justness and reasonableness.[11] For example, a rate may contain a non-cost component designed to encourage exploration and development, *Mobil Oil Corp.* v. *FPC, supra,* at 320. Moreover, even while holding that justness and reasonableness cannot be satisfied solely by reference to market price, this Court in *Texaco* made clear that market price "may certainly be taken into account along with other factors."[12] Indeed, the Commission itself has recently recognized its authority to consider intrastate rates in determining just and reasonable prices and has determined it is "imperative to correlate intrastate sales to interstate rate making . . . ."[13] Further,

[10] *Texaco* was decided by this Court on the *same day* that *Mobil* was decided. Thus, adoption of the Commission's view would lead to the untenable conclusion that this Court denied by implication in *Texaco* the very same authority it simultaneously and expressly upheld in *Mobil.* Clearly, the Commission has misapprehended the *Texaco* holding.

[11] *FPC* v. *Texaco,* 417 U.S. 380, 397 (1974).

[12] *Id.,* at 399.

[13] *Continental Oil Co.* v. *FPC,* 519 F.2d 31, 34 (5th Cir. 1975).

as in this case, a price may be based on costs. As the Court below held, whether the price increase is just and reasonable under such circumstances depends upon the prudence of those costs. The Commission has the authority and responsibility under Section 4(a) of the Gas Act to consider the relevant facts and permit the price increase if the facts show it to be just and reasonable. Both *Mobil* and *Texaco* confirm that authority.

II.

POSSESSION OF AUTHORITY ENHANCES RATHER THAN UNDERMINES THE COMMISSION'S ABILITY TO PERFORM ITS DUTIES

Curiously, the Commission asserts that possessing authority to permit increased royalty costs to be included in producer rates if those costs meet the statutory test will undermine its ability to perform its statutory duties (Pet. 9, 15). That assertion necessarily ignores the scope of the Commission's duty under the Gas Act.

It is well-settled that the Commission's ultimate function is to assure an adequate supply of gas to interstate consumers at the lowest reasonable rate and that the rates set under Section 4 of the Gas Act must be just and reasonable to both the consumer and the seller.[14] In order to accomplish that overriding objective, the Commission is obligated to consider fully the effects of its actions and to consider the myriad of factors bearing upon the end result and upon the rates it sets.

The myriad of considerations in any particular case may demonstrate that permitting a producer to recover an incremental royalty cost would indeed accomplish the objectives established by the Gas Act and that a refusal to so permit would be destructive of those objectives. Nevertheless,

[14] *Mobil Oil Corp.* v. *FPC,* 417 U.S. 283, 321 (1974); *Permian Basin Area Rate Cases,* 390 U.S. 747, 776, 793 (1968).

under its restrictive view of its authority, the Commission would be unable to permit the more desired result *regardless of the facts or probable end result of its action* if the royalty increment exceeded the royalty component of its previously-established rates. On the other hand, if the Commission does have the necessary authority it will be in a position to weigh all the factors involved and make a rational decision one way or the other on the merits. We fail to perceive how the Commission's having the ability to consider all factors and decide a case on the merits will undercut its ability to carry out its mandate under the Gas Act, and the Commission has not set forth any reasons supporting its statement. Under these circumstances, there is no reason to issue a writ of certiorari because there is no possibility of a result which would impair the Commission's fulfillment of its duties.

The Commission attempts to distract one's attention from this situation by suggesting that this Court can solve all problems arising from royalty litigation by either (1) "reshaping" *Mobil Oil Corp.* v. *FPC,* 463 F.2d 256 (D.C. Cir. 1971), *cert. denied,* 406 U.S. 976 (1972), which held that royalty owners/lessors are not subject to the Gas Act (Pet. 17) or (2) holding that "market value" leases do not require royalty payments based on rates in excess of Commission ceilings (Pet. 18).

Of course, neither alternative is required if the Commission has authority to address the merits of the price increase request as we believe it does. More significantly, however, the issues which would have to be addressed in attempting either alternative are not in this case. First, the question of jurisdiction over royalty owners has been resolved adversely to the Commission, and certiorari was denied. The Commission's statement that the Court need not hold royalty owners "fully" jurisdictional, but only partly so, demonstrates the thinness of that straw. Second, the issue of what "market value" leases require in the way of royalty payments was not litigated in this case and is not

at issue — it is still pending as an issue in the litigation which Pennzoil's settlement seeks to terminate. Consequently, neither of those "issues" can serve as justification of, or as showing a need for, a writ of certiorari in this case.

III.

THE COMMISSION'S AUTHORITY TO GRANT THE PRICE INCREASE REQUEST IS THE ONLY ISSUE POSED BY THIS CASE

The Commission asserts this case poses the question whether the Commission has the authority to grant the abandonment request. The Commission's authority to grant the abandonment, however, is clearly set forth in Section 7(b) of the Act, 15 U.S.C. § 717f(b), which, as pertinent here, authorizes the Commission to allow abandonment if "the present or future public convenience or necessity permit. . . ." The clear language of the Act precludes any serious question as to whether the Commission has the authority to determine whether the abandonment requested by Pennzoil Producing is or is not permitted by the public convenience or necessity. And, in fact, no such question is presented because *the Commission in Opinion No. 753 did not deny its authority* to assess the abandonment alternative on the merits. Rather, the Commission exercised that authority and denied the request based on its assessment that the facts did not justify abandonment.

The Court below merely determined that the abandonment request must be reconsidered because the Commission failed to consider the possibility of the interstate market losing all of the gas in the event of lease termination. The Commission's authority to grant the request if

deemed justified was never in issue either at the Commission level or before the court below.[15] It therefore is not an issue presented by this case.[16]

CONCLUSION

For the foregoing reasons Pennzoil Producing submits that the petition for a writ of certiorari should be denied.

Respectfully submitted,

A. DUNCAN GRAY, JR.
Vice President and
General Attorney
Pennzoil Producing Company
3100 Pennzoil Place
Houston, Texas 77001

JERON STEVENS
STEPHEN M. HACKERMAN
Baker & Botts
3000 One Shell Plaza
Houston, Texas 77002
(713) 229-1234

Counsel For Respondent
Pennzoil Producing Company

[15] The Commission apparently recognizes the fact, for it admits (Pet. 15, 16) that in Opinion 753 it denied abandonment because of its finding that the abandonment request did not meet the statutory test.

[16] *See Burlington Truck Lines, Inc.* v. *U.S.*, 371 U.S. 156, 168-9 (1962); *SEC* v. *Chenery Corp.*, 332 U.S. 194, 196 (1947).

CERTIFICATE OF SERVICE

I hereby certify that I have served three copies of Pennzoil Producing Company's Brief In Opposition on counsel of record for the other parties by depositing copies of it in the United States Mail, postage prepaid, on December 2, 1977.

JERON STEVENS

No. 77-648

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

FEDERAL ENERGY REGULATORY COMMISSION,
Petitioner

v.

PENNZOIL PRODUCING COMPANY, *ET AL.*,
Respondents.

On Petition For A Writ of Certiorari To the United States Court of Appeals For The Fifth Circuit

BRIEF OF RESPONDENT UNITED GAS PIPE LINE COMPANY IN OPPOSITION

WILLIAM B. CASSIN
Executive Vice President
and General Counsel
PHILLIP D. ENDOM
Vice President and
Associate General Counsel
LEE M. HUBER
700 Milam
P. O. Box 1478
Houston, Texas 77001
DONALD R. ARNETT
AUSTIN & ARNETT
1938 Bank of the Southwest Bldg.
Houston, Texas 77002
Attorneys for Respondent United Gas Pipe Line Company

Alpha Law Brief Co., One Main Plaza, No. 1 Main St., Houston, Texas 77002

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On Petition For A Writ of Certiorari To the United States Court of Appeals For The Fifth Circuit

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BRIEF OF RESPONDENT UNITED GAS PIPE LINE COMPANY IN OPPOSITION

Respondent United Gas Pipe Line Company (United) submits the following brief in opposition to the petition for a writ of certiorari which has been filed by the Federal Energy Regulatory Commission (Commission).[1]

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1. On September 30, 1977, the Federal Power Commission ceased to exist and its functions were transferred to the Secretary of Energy and the Federal Energy Regulatory Commission, which was activated on October 1, 1977. References to the Commission are to the Federal Power Commission prior to October 1, 1977, and to the Federal Energy Regulatory Commission on and after October 1, 1977.

STATEMENT OF THE CASE

Pennzoil Producing Company (Pennzoil) and Shell Oil Company (Shell) sell natural gas produced from the Gibson Field, Terrebonne Parish, Louisiana, to United. A portion of the gas sold to United is produced from acreage covered by leases from Williams, Inc., *et al.* (Williams). The prices Pennzoil and Shell are permitted to collect from United for the sale of the gas are subject to Commission jurisdiction under the Natural Gas Act, 15 U.S.C. § 717 *et seq.*, and to the applicable just and reasonable rates established by the Commission. Williams, however, has claimed that under its leases it is entitled to the payment of royalties on the basis of the market value of the gas rather than on the basis of the regulated price.[2] As a result of this claim, Pennzoil and Shell asked a Louisiana state court to declare that Pennzoil and Shell were paying correct royalties.[3] By reconventional demand Williams asked the state court to declare the leases terminated, to assess damages for the alleged underpayment of royalties, and, in the event the leases were not terminated, to declare that future royalties must be based on prices alleged by Williams to be the market value. Subsequently, Pennzoil, Shell and Williams entered into a settlement agreement. Pursuant to its terms, Pennzoil and Shell sought Commission authorization to collect increased rates from United which would reflect the increase in royalty costs as provided for in the settlement agreement, or, alternatively, in the event the Commission denied the requested increases,

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2. *Texas Oil and Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968); *Lightcap v. Mobil Oil Corp.*, 562 P.2d 1, *cert. denied*, October 3, 1977, No. 76-1694.

3. *Shell Oil Co. and Pennzoil Producing Co. v. Williams, Inc., et al.*, Civil District Court for Orleans Parish, Louisiana, Docket No. 573-591 (filed May 24, 1974);

Pennzoil and Shell sought Commission authorization to abandon the sale of the royalty portion of the gas to United.

United intervened in the Commission proceedings on the basis of letter agreements it had executed with Pennzoil and Shell in which United agreed, subject to Commission approval, to pay the increased rates, or, alternatively, to release the royalty portion of the gas from its gas purchase contracts. United executed these agreements after being advised of the pending market value royalty litigation, its possible adverse results, and that in an effort to settle the litigation, Pennzoil and Shell had entered into the settlement agreement with Williams. United took the position that it preferred Commission approval of the increased rate alternative, it being understood that the increases would be reflected in United's jurisdictional rates. Commission approval of this alternative would ensure that all of the gas attributable to the Williams' acreage would remain available to United and its customers. However, if the rate alternative were denied, United then supported Commission approval of the abandonment alternative. Commission approval of the abandonment of the royalty portion of the gas was preferable to the risk of lease cancellation and possible loss of all the gas to the interstate market and would at least keep the working interest portion available to United.

The Commission denied Pennzoil's and Shell's requests for increased rates by holding that it did not have the authority to allow producers increased rates based upon increased royalty costs calculated on a rate in excess of the Commission's just and reasonable rates. In denying the requests for abandonment authorization, the Commission held that neither of the two conditions for

abandonment under Section 7(b) of the Natural Gas Act, 15 U.S.C. § 717f(b), had been met. The Commission found first, that the supply of gas had not been depleted and second, that the present or future public convenience or necessity did not require that abandonment be authorized. The Commission relied upon its Opinion No. 737,[4] for its determination that even if the litigation with Williams were lost and Pennzoil's and Shell's leases were terminated, the gas would remain committed to the interstate market.

On appeal, the United States Court of Appeals for the Fifth Circuit reversed the Commission. The Fifth Circuit held that the Commission erred in failing to realize it had the authority to permit rate relief, as this Court previously had held in *Mobil Oil Corp. v. Federal Power Commission*, 417 U.S. 283 (1974), and remanded the rate relief issue for a determination as to whether the relief requested should be granted. Further, the Fifth Circuit reversed and remanded for further consideration the Commission's rejection of the abandonment alternative. Relying on its decision in *Southland Royalty Co. v. Federal Power Commission*, 543 F.2d 1134 (5th Cir. 1976), *cert. granted*, June 27, 1977, *Federal Power Commission v. Southland Royalty Co.*, No. 76-1587, which reversed Opinion No. 737, the Fifth Circuit held that in denying the abandonment requests, the Commission had acted under the wrong legal premise in assuming that the gas would remain committed to the interstate market if the leases were cancelled as a result of the state court litigation.

4. *El Paso Natural Gas Co.*, Opinion No. 737, Docket No. CP75-209 (July 11, 1975), *reh'g denied*, Opinion No. 737-A (September 3, 1975).

REASONS FOR DENYING THE WRIT

I.

THE COMMISSION HAS AUTHORITY TO GRANT INDIVIDUALIZED RELIEF TO NATURAL GAS PRODUCERS FOR ROYALTIES ACTUALLY INCURRED.

1. This Court's opinion in *Mobil Oil Corporation v. Federal Power Commission* expressly authorized the granting of relief from royalty obligations based upon a price higher than the regulated rate.

In its Petition, the Commission has posed the question whether the Commission has authority to grant to natural gas producers individualized rate relief for royalty costs actually incurred when those costs are based on the unregulated market price of natural gas. This question has been answered in the affirmative by the Court of Appeals for the Fifth Circuit in *Placid Oil Co. v. Federal Power Commission*, 483 F.2d 880 (5th Cir. 1973), and by this Court in *Mobil Oil Corp. v. Federal Power Commission, supra*, affirming *Placid*.

In *Placid*, the Fifth Circuit reviewed and upheld the Commission's Opinion No. 598 which established area rates for Southern Louisiana, and, in response to Mobil Oil Corporation's complaint that the Commission failed to provide for an adjustment in area rates to compensate for anticipated higher market value royalty costs, the Fifth Circuit stated:

> "If as subsequent events develop, the producers are put in a bind by their royalty obligations, they may

certainly petition the FPC for individualized relief. *Permian* contemplated it." 483 F.2d at 911.

Placid was affirmed by this Court *sub nom. Mobil Oil Corp. v. Federal Power Commission, supra,* in which this Court expressed complete agreement with the Fifth Circuit:

> "Mobil argues that . . . the 1971 rate schedules must take into account the possibility of higher royalty obligations. We agree with the Court of Appeals that Mobil's argument is hypothetical at this stage and that in any event an affected producer is entitled to seek individualized relief." 417 U.S. at 328.

The claim for higher royalties and the state court litigation have put Pennzoil and Shell in the bind mentioned in *Placid*.[5] As the Fifth Circuit noted in its opinion below:

> "Pennzoil and Shell have been put in such a bind. If they lose the state court litigation, they are faced either with termination of their leases, which could divert the entire amount of gas from interstate commerce, or with increased royalty payments, which would absorb funds otherwise available for exploration and development." 553 F.2d at 488.

5. Assuming that it does not have the authority to grant relief to a producer caught in such a bind, the Commission suggests that this Court either modify the holding in *Mobil Oil Corp. v. Federal Power Commission*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied*, 406 U.S. 976 (1972), to give the Commission limited jurisdiction over royalty owners, or that the Court determine that lower courts err when they interpret "market value" leases that underlie interstate sales as requiring royalty payments based on the intrastate market price of gas. Pet. 16. Neither suggestion need be considered by this Court because the Commission does have the authority to grant relief.

However, when Pennzoil and Shell petitioned the Commission for individualized relief in accordance with *Placid* and *Mobil*, they were told by the Commission that it had no authority to grant relief, as follows:

> "Accordingly, we believe that we are not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates."[6]
>
> "The Commission does not have the power to base a part of the regulated price on the unregulated market value of intrastate gas."[7]

If the Commission were correct, the holding in *Placid* and *Mobil* would be meaningless. It would be idle for the Courts to state that producers "put in a bind by their royalty obligations . . . may certainly petition the FPC for individualized relief" and that "an affected producer is entitled to seek individualized relief" if the Commission does not have the authority to grant relief. The Fifth Circuit correctly noted that the Commission erred when it "failed to realize it had the authority to grant relief", 553 F.2d at 486, and correctly held that "Petitioners followed the proper procedures in petitioning the Commission for special relief and were entitled to a determination of the merits of their requests." 553 F.2d at 488.

6. *Pennzoil Producing Company and Shell Oil Company*, Opinion No. 753, Docket Nos. RI76-8, RI76-10 (January 30, 1976), Pet. 23a.

7. *Pennzoil Producing Company and Shell Oil Company*, Opinion No. 753-A, Docket Nos. RI76-8, RI76-10 (February 27, 1976), Pet. 31a.

2. This Court's opinion in *Federal Power Commission v. Texaco Inc.* is consistent with *Mobil*.

The Commission recognizes in its Petition that *Mobil* specifically authorizes an affected producer "to seek individualized relief" for "higher royalty obligations" based upon the unregulated market value, but curiously does an about face and argues that *Federal Power Commission v. Texaco Inc.*, 417 U.S. 380 (1974), denies it authority to grant individualized relief for royalty costs higher than those provided for in the regulated rate.[8] In effect, the Commission found *Mobil* and *Texaco* to be inconsistent and gave controlling weight to *Texaco*.

Texaco was handed down by this Court on the same day that this Court affirmed *Placid* in *Mobil*. This Court obviously saw no conflict between *Texaco* and *Mobil*, and no conflict exists.

In *Texaco*, this Court reviewed the Commission's Order No. 428 dealing with the regulation of "small producer" sales. The Court of Appeals for the District of Columbia had read Order 428 as providing ". . . a pure market standard for the approval of the purchased gas costs of large producers and pipelines, a standard which fell short of the requirements . . ." of the Natural Gas Act. This Court read the Order in the same manner and remanded the Order to the Commission. In *Texaco* this Court was concerned with the use of the market price as the *sole* determinant of the just and reasonable rate, thereby equating the market price and the just and reasonable rate, or, as this

8. The settlement rate in this proceeding is less than the market value, but the Commission equated the two by stating that it may not grant individualized relief "for additional royalty payments which are based on other factors than the regulated rate". Pet. 22a.

Court stated, ". . . the prevailing price in the market place cannot be the final measure of 'just and reasonable' rates mandated by the Act." 417 U.S. at 397.

The Commission indicated in its brief to this Court in *Texaco* that the standard the Commission planned to use would not be limited to market prices but would include other considerations, such as producer's costs and the amount of gas dedicated under the contract. This Court noted this *post hoc* rationale and concluded:

> "Had the order unambiguously provided what the Commission now asserts it was intended to provide, we would have a far different case to decide." 417 U.S. at 397.

Texaco proscribes the use of the unregulated market price as the *sole* standard for determining the just and reasonable rate, but it does not proscribe the use of the unregulated market price as one element to be considered in determining the just and reasonable rate. On the contrary, this Court expressly stated in *Texaco* that it did not "mean that the market price would never, in an individual case, coincide with just and reasonable rates or not be a relevant consideration in the setting of area rates . . .; it may certainly be taken into account . . ." 417 U.S. at 399. If the unregulated market price may be taken into account in setting the area rate itself, *a fortiorari* it may be taken into account in granting individualized relief from the area rate.

3. The higher royalty obligation is an actual cost, and individualized relief may be granted for higher costs.

The Commission has adopted a cost-based regulation and bases its just and reasonable rates upon estimated

industrywide average costs. This methodology was applied to a geographical area of the nation and approved by this Court in *Permian Basin Area Rate Cases,* 390 U.S. 747 (1968). The establishment of a national rate by this methodology was approved in *Shell Oil Company v. Federal Power Commission,* 520 F.2d 1061 (5th Cir. 1975), *cert. denied,* 426 U.S. 941 (1976). In *Shell,* the Fifth Circuit noted that the overall cost determination was based upon an evaluation of thirteen individual cost components, including such components as Successful Well Cost, Lease Acquisition Cost, Cost of Other Production Facilities, and Royalty Expense. Each component is the estimated actual cost of that component. For example, the estimated Successful Well Cost is determined by reference to the actual market cost of drilling and equipping a successful well, and Lease Acquisition Cost is determined by reference to the actual market cost of leases bought from private landowners and governmental entities, including the Department of the Interior. The determination is intended to take into account actual costs.

As noted in *Shell,* Royalty Expense is one of the cost components of an area rate or nationwide rate. In the overall cost determination:

> "*Royalty Expense* represents the percentage of the gross receipts which a producer must pay to the landowner for the privilege of extracting from the reserves underlying his land. It was computed by applying a percentage to the gross receipts." *Shell Oil Company v. FPC,* 520 F.2d at 1068.

In "applying a percentage to the gross receipts", the Commission treated the regulated rate itself as being the

gross receipts and applied a percentage to the regulated rate to determine the actual cost of Royalty Expense.

Some leases do provide for a landowner's royalty of a "percentage of the gross receipts", and the actual cost of the Royalty Expense of these leases is considered in the area rate or nationwide rate. However, some leases provide for a percentage of the market value of the gas, even though the market value exceeds the gross receipts from the sale of the gas, and for those leases the royalty paid is a percentage of the market value, not a percentage of the gross receipts. Since the Royalty Expense in an area or national rate determination is computed "by applying a percentage to the gross receipts" instead of by applying a percentage to the market value, the actual royalty cost in market value leases exceeds the Royalty Expense allowed in the area or national rate.

This is the exact fact situation foreseen by Mobil Oil in *Placid* and *Mobil* when it argued that for some leases it anticipated being required to pay royalties computed as a percentage of market value (not reflected in the Royalty Expense component) instead of being computed as a percentage of the regulated rate (which is reflected in the Royalty Expense component).[9] Mobil Oil's complaint in *Placid* and *Mobil* was the failure to take this anticipated higher market value royalty expense into account. This Court noted that "Mobil's argument is hypothetical at this stage and that in any event an affected producer is entitled to seek individualized relief." The

9. The Supreme Court of Texas had held in *Vela, supra,* that market value leases could require the producer to pay a royalty based on a market value rate higher than the regulated rate, and the D.C. Circuit had held, in *Mobil Oil Corp. v. Federal Power Commission, supra,* with certiorari denied, that the Commission does not have jurisdiction over royalty owners.

very situation foreseen by Mobil Oil and considered by this Court is no longer hypothetical. Pennzoil and Shell are faced with paying royalties measured by market value rather than by gross receipts. This Court has held that they are entitled to seek individualized relief, and the Commission has the authority to grant relief.

The Commission has provided for individualized relief in Section 154.105(j) of its Regulations and Sections 2.56a and 2.56b of its Statement of General Policy and Interpretations Under the Natural Gas Act (18 C.F.R. § 154.105(j) and 18 C.F.R. § 2.56a and 2.56b). The Commission has granted relief for such costs as compression and remedial well work, even though these costs are determined by an uncontrolled market, and the Fifth Circuit correctly noted that "the Commission has failed to suggest why royalty costs in an uncontrolled market are any different from any other cost." 553 F.2d at 488. *Texaco* does not proscribe rate relief for such costs as repair and maintenance of equipment, even though the actual cost for which relief is granted reflects the unregulated market value of labor and material. Neither does *Texaco* proscribe relief for actual royalty costs, even though the actual costs of the royalty reflects the unregulated market value of natural gas.

II.

NO QUESTION OF COMMISSION ABANDONMENT AUTHORITY IS BEFORE THIS COURT.

In its Petition, the Commission states that a question presented is whether the Commission has *authority* under Section 7(b) of the Natural Gas Act to permit abandonment of certificated interstate service of the royalty share of the gas and thereby permit the royalty owner to take its royalty share of the gas in kind. This question is raised for the first time in this Court.

Under Section 7(b) of the Natural Gas Act, abandonment can be granted on a showing that the available supply of gas is depleted to the extent that the continuation of service is unwarranted or that the present or future public convenience or necessity permit such abandonment. In this instance, the Commission made a determination on the merits, applying the standards of Section 7(b).

The Commission correctly held that the supply of natural gas had not been depleted and that this standard of 7(b) had not been satisfied. The Commission also held that, based upon the record, the present or future public convenience or necessity standard of Section 7(b) did not permit abandonment. It was argued to the Commission that the choice was between losing the royalty owner's share of the gas from the interstate market or risking the loss of all of the gas from the interstate market if the leases are cancelled, and, therefore it was in the public interest to grant abandonment if rate relief were denied. The Commission stated that its holding in Opinion No. 737 would prevent the royalty owners from terminating deliveries in interstate commerce even if the leases were cancelled as a result of the state court litigation. The Commission did consider the abandonment question on the merits and found that neither standard of Section 7(b) of the Act had been satisfied.

The Fifth Circuit reversed Opinion No. 737 in *Southland Royalty Co. v. Federal Power Commission, supra,*

and this Court has granted certiorari. Because the Fifth Circuit had reversed Opinion No. 737, upon which the Commission had relied, the Fifth Circuit held that the Commission was acting under the wrong legal premise and remanded this issue for further consideration on the merits.

No party to this proceeding questioned the Commission's authority to permit abandonment of the royalty share of the gas; the Commission itself did not question its authority to permit abandonment of the royalty share of the gas; and the Fifth Circuit did not question the FPC's authority to permit abandonment. The question of Commission authority to permit abandonment was not raised in the Court of Appeals and is not before this Court.[10]

10. *Neely v. Martin K. Eby Const. Co.*, 386 U.S. 317 (1967); *State of California v. Taylor*, 353 U.S. 553 (1957).

CONCLUSION

For the foregoing reasons, Respondent United Gas Pipe Line Company prays that the petition for a writ of certiorari be denied.

Respectfully submitted,

WILLIAM B. CASSIN
Executive Vice President
and General Counsel

PHILLIP D. ENDOM
Vice President and
Associate General Counsel

LEE M. HUBER
700 Milam
P. O. Box 1478
Houston, Texas 77001

DONALD R. ARNETT
AUSTIN & ARNETT
1938 Bank of the Southwest
Bldg.
Houston, Texas 77002

Attorneys for Respondent
United Gas Pipe Line Company

December 7, 1977

IN THE
Supreme Court of the United States
OCTOBER TERM, 1977

NO. 77-648

FEDERAL ENERGY REGULATORY COMMISSION,
Petitioner,

v.

PENNZOIL PRODUCING COMPANY, ET AL.,
Respondents.

BRIEF OF SHELL OIL COMPANY IN OPPOSITION TO THE PETITION OF THE SOLICITOR GENERAL FOR WRIT OF CERTIORARI

THOMAS G. JOHNSON
JOSEPH H. FIELDS
Attorneys for
SHELL OIL COMPANY
One Shell Plaza
P. O. Box 2463
Houston, Texas 77001

December 6, 1977
Houston, Texas

Alpha Law Brief Co., One Main Plaza, No. 1 Main St., Houston, Texas 77002

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STATEMENT OF POSITION AND SUMMARY OF ARGUMENT

Shell Oil Company ("Shell"), Respondent herein and Petitioner in the Court of Appeals below,[1] respectfully submits that the Petition in the captioned case should be

1. Separate Petitions for Review from the same Commission Orders were filed by Pennzoil Producing Company (Case No. 76-1626), Shell Oil Company (Case No. 76-1831) and United Gas Pipe Line Company (Case No. 76-2128), in the U.S. Court of Appeals for the Fifth Circuit. These cases were consolidated by that Court for purposes of briefing, argument, and decision.

denied and the Opinion of the Court of Appeals for the Fifth Circuit be permitted to stand. The Questions Presented by Petitioner do not involve any discretionary action by the Federal Power Commission (now succeeded by the Federal Energy Regulatory Commission, and herein called "Commission"). They involve findings by the Commission that *it had no power or authority* under the Natural Gas Act and the decisions of this Court to grant the relief requested by Shell. The Court of Appeals properly found that the Commission *did* have authority to grant either of the two alternative forms of relief requested, and remanded the case to the Commission for consideration of the case on the merits. Should the Court of Appeals' decision be reversed and the Commission upheld, this action, when considered with other decisions of the Commission, will result in denying Shell the opportunity to recover its reasonable and legitimate costs on the leases here in question in *any* proceeding before the Commission.

ARGUMENT

I. The Commission Has Misconstrued This Court's Decision in *F.P.C. v. Texaco Inc.*[2] Both in Its Decision Below And Its Petition Here.

The basic fallacy in the Commission's Opinion below, and its Petition here, is a mistaken reading of the Court's Opinion in *Texaco, supra.* In *Texaco,* this Court reversed an attempt by the Commission to regulate prices for sales in interstate commerce by small producers *solely* on the basis of unregulated intrastate market prices. This Court went ahead to point out that had the Commission considered "other factors" as well as the market price, the decision would have been different,[3] citing *Austral Oil Co. v. F.P.C.,* 428 F.2d 407, 441 (C.A. 5), certiorari denied, 400 U.S. 950.[4] To read *Texaco* as precluding *any* consideration of market values or non-cost economic factors would place it in conflict with this Court's decision in *Mobil Oil Corp. v. F.P.C.,* 417 U.S. 283, 317-320, decided in the same term, as well as this Court's earlier decisions in *Permian Basin Area Rate Cases,* 390 U.S. 747, 796-798 (1968) and *F.P.C. v. Sunray DX Oil Co.,* 391 U.S. 9, 32 (1968). *Permian* specifically authorized the Commission to consider factors other than costs in determining producer rates under Sections 4 and 5, and *Sunray* authorized the Commission to consider contract prices which had not received Commission approval in fixing ceiling prices permitted under Section 7 of the Natural Gas Act.

2. 417 U.S. 380 (1974).

In fact, in *Mobil, supra,* this Court suggested the very relief that the producers sought here, and which the Commission now asks this Court to find it has no power to grant. In that case Mobil Oil Corporation, Petitioner, attacked the Commission's *Southern Louisiana Area Rate Decision,* 46 F.P.C. 86, affirmed *Placid Oil Co. v. F.P.C.,* 483 F.2d 880 (5th Cir. 1973), on the grounds that the Commission had failed to consider an adjustment to the area ceiling rate for higher royalty costs based on market

3. The record clearly reflects that the settlement price agreed to by Shell and the Williams reflected "other factors" besides the intrastate price for gas in the area, including th FPC ceiling prices, the termination of the litigation to cancel the lease, and the need to drill additional wells free of the cloud on the title created by the lawsuit.

4. 417 U.S. at 397-99.

value royalty provisions of the type involved here. This Court said:

> "We agree with the Court of Appeals that Mobil's argument is hypothetical at this stage and that in any event an affected producer is entitled to seek individualized relief."
>
> * * *
>
> " 'If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief. Permian contemplated it.' 483 F.2d at 911" (417 U.S. at 328)

As the Court of Appeals found, "Shell and Pennzoil have been put in such a bind" (553 F.2d at 488). The record reflects that if the lessor prevails in the State Court action,[5] and all special relief is denied, Shell will suffer a net *loss* of 3.5 cents for each Mcf of gas it sells from one of the two leases here in question.

However the royalty due to the lessor is determined, it remains a *cost* to the lessee-producer. The possibility that the lessor's percentage royalty may be based on some price higher than the lessee is entitled to receive for the gas under Commission regulation, is a cost which the Commission has *not* taken into account in establishing the area and national ceiling rates for producers, see *Mobil, supra; National Rate Proceeding for New Gas,* 51 F.P.C. 1446, 52 F.P.C. 1604,[6] affirmed, *Shell Oil Co. v. F.P.C.,* 520 F.2d 1061 (5th Cir. 1975), certiorari denied, *sub nom. California Co. v. F.P.C.,* 426 U.S. 921 (1976); *National Rate Proceeding for Sales of Natural Gas Produced From Wells Commenced Prior to January 1, 1973,* Opinion Nos. 749 and 749-C, ___ F.P.C.___ and ___ F.P.C. ___, respectively, appeal pending, *Tenneco Oil v. F.E.R.C.,* Case Nos. 76-2960, *et al.,* (5th Cir.). It is particularly ironic that in Opinion No. 749-C (at page 27 of the mimeo opinion), *supra,* issued July 19, 1976, the Commission again rejected any adjustment to the national ceiling rate for royalty calculated at a rate above the Commission's ceiling price on the grounds that "a producer affected by higher royalty obligations is entitled to seek individualized relief", citing *Mobil* and *Placid, supra.* The Commission's position appears to be that the producer is always in the wrong case to obtain relief from the additional costs created by the market value royalty provision.

5. The result which cannot be ignored, in the light of *J.M. Huber Corporation v. Denman,* 367 F.2d 104 (5th Cir. 1966) and *Texas Oil and Gas Corp. v. Vela,* 429 S.W.2d 866 (Tex. 1966).

6. The cost study utilized by the Commission to establish the national ceiling rate in this case assumed a national average royalty of 16 percent, 52 F.P.C. at 1690.

II. Under Section 7(b) Of The Natural Gas Act, The Commission Has Authority To Grant Partial Or Total Abandonment Upon A Finding That "The Present Or Future Public Convenience And Necessity Permit Such Abandonment".[7]

Petitioner seeks to deny the Commission a power clearly granted it under Section 7(b) of the Natural Gas Act, which authorizes the Commission to grant abandonment upon a finding that such abandonment is in the present or future public convenience and necessity. The record contains ample evidence upon which such a finding

7. 15 U.S.C. § 717f(b).

could be made. But the Commission never considered this evidence, concluding on the basis of its decision in *El Paso Natural Gas Co.*, 54 F.P.C. 145, reversed *sub nom. Southland Royaly Co. v. F.P.C.*, 543 F.2d 1134 (C.A. 5), certiorari granted June 27, 1977, *California, et al. v. Southland Royalty Co., et al.*, Case Nos. 76-1114, *et al.* October Term, 1977, that even if Shell's leases were cancelled, or made uneconomic by refusal by the Commission to allow recovery of royalty costs, the gas would nevertheless remain committed to interstate commerce. The Court of Appeals found that the grounds relied upon by the Commission swept away by its reversal of *Southland*,[8] and therefore the Commission must consider the issue on the merits. Obviously, if this Court sustains the decision of the Court below in *Southland*, it must sustain the Court below here. But even if the *Southland* decision is reversed, the Commission's decision on the abandonment question here, still cannot stand. The Commission is stating that *as* a *matter of law* it has *no authority* to grant abandonment under the circumstances of this case.

In taking this position, the Commission completely ignored the undisputed evidence that its actions will result in the confiscation of Shell's leases if the royalty owner prevails in his litigation. The fact that the record shows that two additional wells planned on these leases have been indefinitely deferred because of the litigation and the Commission's position, is not considered, even though the pipeline purchaser, United Gas Pipe Line Company curtailed the supply of gas to over 50 percent of its contract obligations last winter. The ability, or the inclination, of the royalty owner to additionally develop the leases if he obtains the title thereto, is not considered. The only question considered by the Commission is whether the loss of Shell's lease could result in loss of the seven-eights (7/8th) of the gas stream to the interstate market. Having concluded (we believe erroneously, for all of the reasons given by the Court of Appeals in *Southland, supra*) that it could not, the Commission takes the position that it *has no authority* to consider the record, or any other factors which may bear on its responsibility to determine whether abandonment of the one-eighth (1/8th) interest *would* be in the "present or future public convenience and necessity". The Court of Appeals properly found that is not the law.

8. See the Court of Appeals' language at page 9a of Appendix A to the Petition for Writ. The first three sentences of that last paragraph of the Opinion were *not* deleted on rehearing, see Appendix C.

III. The "End Result"[9] Of The Commission's Position Here, Together With Its Other Decisions, Is To Confiscate Shell's Property Without Due Process Of Law.

As previously discussed, having denied any consideration of the market value royalty problem in the area and national rate cases determining producer ceiling rates, the Commission now seeks to deny relief in an individual proceeding for special relief. The result is confiscation of the producers' leases, as the margin between the static ceiling price and the increasing royalty cost becomes narrower and finally disappears. Yet, the Commission's position is that it cannot even *consider* this question, in a specific proceeding and record on which the issues are presented. In other words, there is no proceeding before

9. Under *Permian, supra,* and *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), it is the "end result" of the Commission's decision which is the subject of Court review.

the Commission where the producer can obtain relief from this confiscation of his property, even though one side of the pincers, the ceiling rate, is clearly under the Commission's control.[10]

The Commission suggests in its Petition (p. 17) that this Court could resolve the question by reconsidering its denial of certiorari from the 1972 decision of the Court of Appeals for the District of Columbia Circuit in *Mobil Oil Corporation v. F.P.C.*, 463 F.2d 256 (1971), and find that "the producer/lessees need not pay royalties which exceed the amounts permitted by the Commission to be passed on to jurisdictional pipelines". Shell would certainly support such a finding. In fact, this is basically the same result urged on this Court in Shell's Petition for Certiorari from the same *Mobil* decision, Case No. 71-1191, October Term, 1971. That Petition was denied by this Court on June 7, 1972, 406 U.S. 976.[11]

Another alternative offered by the Commission (p. 18) is the reconsideration by this Court of its denial of certiorari from the decision of the Kansas Supreme Court in *Mobil Oil Corp. v. Lightcap,* Case No. 76-1694, certiorari denied October 3, 1977. Shell would also support that result.

Unless and until the Court reverses those two cases, together with *J. M. Huber Corporation v. Denman, supra* and *Texas Oil and Gas Corp. v. Vela, supra,* the

10. Shell could not have anticipated this problem and contracted against it, as one lease was executed before the passage of the Natural Gas Act, and the other before this Court's decision in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954).

11. This Court denied a similar Petition for Writ of Certiorari by the Solicitor General (Case No. 71-1326, October Term, 1971) by the same Order.

Commission cannot escape the responsibility to at least allow Shell the opportunity to recover its increased royalty costs a hearing on the merits in its individual proceeding for special relief, the procedure indicated by this Court in *Mobil Oil Corp. v. F.P.C.*, 417 U.S. 238 (1974) to be the appropriate one. Due process requires that such a hearing be permitted. The decision of the Court of Appeals directing the Commission to hear the case on the merits should be affirmed, and the Petition for Writ of Certiorari denied.

Respectfully submitted,

/s/ THOMAS G. JOHNSON

THOMAS G. JOHNSON
JOSEPH H. FIELDS
Attorneys for
SHELL OIL COMPANY
One Shell Plaza
P. O. Box 2463
Houston, Texas 77001

December 6, 1977

No. 77-648

In the Supreme Court of the United States

OCTOBER TERM, 1977

FEDERAL ENERGY REGULATORY COMMISSION,
PETITIONER

v.

PENNZOIL PRODUCING COMPANY, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY MEMORANDUM FOR THE FEDERAL ENERGY REGULATORY COMMISSION

WADE H. MCCREE, JR.,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

ROBERT R. NORDHAUS,
General Counsel,
Federal Energy Regulatory Commission,
Washington, D.C. 20426.

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OCTOBER TERM, 1977

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1. Respondents contend[1] that the Commission's authority to pass through to interstate customers royalty costs based on the unregulated price of natural gas was established by this Court in *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283, affirming *Placid Oil Co.* v. *Federal Power Commission*, 483 F. 2d 880 (C.A. 5). The contention is erroneous. In the orders under review in those cases, the Commission established just and reasonable rates for natural gas produced from the Southern Louisiana Area. The royalty issue was only one

[1]Pennzoil Br. in Opp. 6-8; Shell Br. in Opp. 3-5; United Gas Pipe Line Br. in Opp. 5-7.

of numerous issues considered by the Commission[2] and reviewed by the courts in that proceeding. The Commission found the issue to be premature in the context of the area rate proceeding. The court of appeals agreed with the Commission, finding specifically (483 F. 2d at 911; emphasis in original):

> [W]e are not willing to alter or stay the implementation of area wide rates for the entire industry merely on the basis of what *might* happen to *some* producers' costs *if* this statement of the law prevails.
>
> If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they [might] certainly petition FPC for individualized relief. * * * [W]e find it to be far preferable to speculative prophesies of future royalty components. If the royalty obligations are such as to make the rates established by Op. 598, and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will certainly have recourse to the administrative process.

This Court fully agreed "with the Court of Appeals that Mobil's argument is hypothetical at this stage and that in any event an affected producer is entitled to seek individualized relief." 417 U.S. at 328.

It is thus clear that the Commission and the courts in *Mobil* expressly declined to decide the merits of the principal issue presented in this case, which they viewed as premature. The observation of this Court and the court of appeals in *Mobil* that producers might seek individualized relief from the Commission when and if the issue became

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[2]See Opinion No. 598, 46 F.P.C. 86, rehearing denied, Opinion No. 598-A, 46 F.P.C. 633.

ripe—which is exactly what has happened in this proceeding—cannot be taken as expressing a view on the merits of such a claim for relief, especially when the courts noted that the merits were not ripe for decision.

2. Respondents also contend[3] that their increased royalty payments, which the Commission said it could not permit them to pass through to interstate customers, were not based on the unregulated intrastate market price because the amount of the royalties to be paid resulted from a negotiated settlement agreement. That claim ignores the essential fact that it was the claim by the lessor Williams for higher royalty payments based on the "market value" royalty clause in the oil and gas leases that led to the lawsuit, the settlement negotiations, the settlement, and the Commission proceedings. As the Commission observed in its opinion, the "impetus of the settlement is the market value of the royalties and no consideration has been given to regulated rates" (Pet. App. D, p. 22a). If we are correct that passing through to interstate customers royalty costs based on the intrastate market price of gas is contrary to the fundamental scheme of the Natural Gas Act and the principles established in *Federal Power Commission* v. *Texaco, Inc.*, 417 U.S. 380, parties should not be able to compel a different result by mutually agreeing on a royalty cost that is somewhat less than the lessor's original "market value" claim.

3. Respondents attempt to distinguish *Texaco, supra,* on two bases. First, they argue that in *Texaco* the Commission had attempted to regulate prices for certain sales in interstate commerce solely by reference to the unregulated market price. Because in the instant case only

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[3]Pennzoil Br. in Opp. 3-4; Shell Br. in Opp. 3, n. 3.

a percentage of the otherwise just and reasonable rate is affected by the higher royalty costs, respondents contend that *Texaco* is not in point.[4] As a factual matter, the contention is incorrect. As we pointed out in our petition (Pet. 12-13), what this Court rejected in *Texaco* was the Commission's attempt to permit pipelines and large producers to pass through to interstate customers one of many components of their costs—namely, the price they paid to small producers for gas, which was an unregulated price. In any event, for purposes of the Commission's obligation under the Natural Gas Act to allow only rates that it determines to be "just and reasonable," it makes no difference whether all or only a portion of the interstate rate is to be determined by the unregulated price of gas. As the Court said in *Texaco* (417 U.S. at 399), "the Act * * * does not say a little unlawfulness is permitted."

Second, respondents attempt to evade the principles set forth in *Texaco* by arguing that royalty costs are no different from any other costs that producers pass on to the consumer, such as drilling costs or the costs of labor. Respondents reason that just as the Commission has no jurisdiction or control over such cost items, so it has no jurisdiction over royalty costs and is obligated to pass them on to the interstate consumer. The flaw in this argument is that the royalty costs in this case have been established by reference to the unregulated market price of the very commodity that Congress has made the subject of regulation. In contrast to the costs of labor, steel, or other elements of production, the possibility that royalty payments could be based on the unregulated price of natural gas creates the type of regulatory "gap" that

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[4]Pennzoil Br. in Opp. 9-10; Shell Br. in Opp. 2-3; United Gas Pipe Line Br. in Opp. 9.

this Court has consistently found unacceptable. *E.g.*, *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 682-684.

4. Finally, in contending[5] that the authority of the Commission to permit abandonment of "royalty gas" is not an issue in this case, respondents have misconceived the second issue presented by the petition. There is, of course, no question that the Commission has authority under Section 7(b) of the Natural Gas Act, 52 Stat. 824, as amended, 15 U.S.C. 717f(b), to permit abandonment of an interstate service of supply gas if it finds, as that section requires, either that the supplying of gas has been "depleted to the extent that the continuation of service is unwarranted" or that "the present or future public convenience or necessity permits such abandonment." Here the Commission's determination that the public convenience and necessity did not permit respondents to abandon "royalty gas" to their lessor in lieu of passing through "market value" royalty costs was essentially a corollary of its conclusion that the basic scheme of the Natural Gas Act does not permit the pass-through of market value royalty costs. The issue of the Commission's authority to permit abandonment of "royalty gas" in the circumstances of this case is therefore directly related to

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[5]Pennzoil Br. in Opp. 13-14; Shell Br. in Opp. 5-7; United Gas Pipe Line Br. in Opp. 12-14.

the first issue presented in the petition, and is squarely presented by the decision below.

Respectfully submitted.

WADE H. MCCREE, JR.,
Solicitor General.

ROBERT R. NORDHAUS,
General Counsel,
Federal Energy Regulatory Commission.

JANUARY 1978.

No. 77-648

In the Supreme Court of the United States

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WADE H. MCCREE, JR.,
Solicitor General,

STEPHEN R. BARNETT,
Deputy Solicitor General,

RICHARD A. ALLEN,
Assistant to the Solicitor General,
Department of Justice,
Washington, D.C. 20530.

ROBERT R. NORDHAUS,
General Counsel,

HOWARD E. SHAPIRO,
Solicitor,

MCNEILL WATKINS, II,
Attorney,
Federal Energy Regulatory Commission,
Washington, D.C. 20426.

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In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION, PETITIONER

v.

PENNZOIL PRODUCING COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-9a)[1] is reported at 553 F.2d 485. The order on rehearing of the court of appeals (Pet. App. 12a-13a) is reported at 558 F.2d 816. The initial opinion and order (Opinion No. 753) of the Federal Power Com-

[1] "Pet. App." references are to the appendix to the petition for certiorari filed by the Federal Energy Regulatory Commission. "A." refers to the Appendix in this Court.

mission (A. 254-263, Pet. App. 14a-26a) and its opinions and orders (Nos. 753-A, 753-B) denying rehearing (A. 290-295, Pet. App. 27a-33a; A. 296-299) are not officially reported.

JURISDICTION

The judgment of the court of appeals was entered on June 6, 1977 (Pet. App. 10a-11a). The Commission's application for rehearing was denied on September 1, 1977 (Pet. App. 12a-13a). The mandate of the court of appeals issued on September 9, 1977. On August 26, 1977, Mr. Justice Powell extended the Commission's time for filing a petition for a writ of certiorari to and including November 3, 1977. The petition was filed on that date and was granted on June 12, 1978 (A. 303). The Court's jurisdiction rests on 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, as amended, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Whether the Natural Gas Act permits the Commission to establish rates for the interstate sale of natural gas that pass through to interstate consumers royalty costs based on the unregulated price of natural gas in the intrastate market.

2. Whether the Commission properly denied a request to permit lessee/producers of natural gas to abandon volumes of gas dedicated to interstate service so that those volumes could be paid as royalties "in kind" to landowner/lessors and sold on the intrastate market.

STATUTES INVOLVED

Sections 4(a) and 7(b) of the Natural Gas Act, 52 Stat. 822, 824, as amended, 15 U.S.C. 717c(a), 717f(b), are set forth as an Appendix, *infra*, p. 1a.

STATEMENT

Respondents Pennzoil Producing Company (Pennzoil) and Shell Oil Company (Shell) sell gas produced from the Gibson Field in Terrebonne Parish, Louisiana, to respondent United Gas Pipe Line Company (United) for resale in interstate commerce, as authorized by certificates of public convenience and necessity issued by the Commission. The gas is produced under leases obtained by Pennzoil and Shell from Williams, Inc. (Williams) dated August 29, 1934, and July 24, 1952. The leases provide for payment to the lessor of royalties equal to fixed fractions—one-eighth under the 1934 lease, one-fourth under the 1952 lease—of the value of the gas produced. That value is to be "calculated at the market rate prevailing at the well," or "calculated at the market price prevailing at the well" (A. 133, 145).

Pennzoil and Shell have always computed and paid their royalties under the leases as fractions of the rates actually received by them for the sale of the gas in interstate commerce, which rates since 1954 have been established by the Commission.[2] In 1973, 1974, and 1975, however, Williams demanded payment by

[2] See *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672.

Pennzoil and Shell of royalties based on intrastate market values of natural gas. Those values assertedly ranged from 35 cents to 70 cents per Mcf (1,000 cubic feet) for the period October 1, 1971, through May 31, 1974, and from $1.30 to $1.40 per Mcf from June 1, 1974, through April 30, 1975 (A. 72-74, 119-121, 160-161). Those intrastate market values substantially exceeded the ceiling rates established by the Commission for the sale of the gas by Pennzoil and Shell.[3] When Pennzoil and Shell refused to pay the higher royalties, Williams purported to terminate the leases for underpayment of the royalties due (A. 160, 255).

In 1974, Pennzoil and Shell filed a petition in a state court in Louisiana seeking a judgment declaring that they were properly discharging their royalty obligations under the leases (A. 75-79). Williams counterclaimed for royalty underpayments in excess of $3.5 million (A. 120). The principal question before the state court was whether the terms "market rate" and "market price" in the royalty provisions of the leases referred to the unregulated intrastate market (as Williams contended) or to the regulated Commission rate at which the gas was actually sold (as Pennzoil and Shell contended) (see A. 91-94).[4]

[3] In 1975, for example, both Pennzoil and Shell received 31.11 cents per Mcf for some of the Gibson field gas sold to United, and 59.88 cents for the remainder (A. 42, 66-67). These rates, which included some adjustments, were established by the Commission's Opinion No. 598, *Area Rate Proceeding (Southern Louisiana Area)*, 46 F.P.C. 86, affirmed *sub nom. Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283; and Opinion No. 699-H, *Just and Reasonable National Rates for Sales of Natural Gas*, 52 F.P.C. 1064, affirmed *sub nom. Shell Oil Co.* v. *Federal Power Commission*, 520 F.2d 1061 (C.A. 5), certiorari denied, 426 U.S. 941.

On June 18, 1975, before the state court ruled on that question, Pennzoil, Shell, and Williams entered into a settlement agreement (A. 15-25). The agreement provided that Pennzoil and Shell would apply to the Commission for authority to pay royalties based, in essence, on the higher of 78 cents per Mcf (increasing 1.5 cents per year after 1975) or 150 percent of the highest area or national rate per-

[4] Royalty provisions based on "market value," "market price," or similar terms appear to be fairly common in natural gas leases, although the Commission has no precise information concerning the number of leases containing such provisions or the volumes of gas covered. The issue whether such provisions refer to the unregulated intrastate market price or to the regulated rate at which the gas is actually sold is currently pending in numerous cases, but has been decided or considered in only a few reported decisions. One of these is *Lightcap* v. *Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1, certiorari denied, 434 U.S. 876, petition for rehearing pending. In *Lightcap* and *Kingery* v. *Continental Oil Co.*, 434 F. Supp. 349 (W.D. Tex.), the courts held that such provisions referred to the unregulated market. Cf. *J. M. Huber Corp.* v. *Denman*, 367 F.2d 104 (C.A. 5). The District of Columbia Circuit, however, expressed a contrary view in *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F.2d 256, 265, certiorari denied, 406 U.S. 976. The courts of Louisiana have not yet ruled on the issue, although one case indicates the Supreme Court of Louisiana's view that the "market value" of gas sold for resale in interstate commerce can be established only by reference to the just and reasonable rate set by the Commission. *Whitehall Oil Co.* v. *Boagni*, 255 La. 67, 229 So.2d 702, 704-705. See also discussion, *infra*, pp. 35-37.

mitted by the Commission, and that they would ask the Commission for authority to "pass through" these increases to their interstate customer, United (A. 16, 18). Alternatively, Pennzoil and Shell would seek Commission authorization to abandon that portion of the gas sold under the leases which was attributable to Williams's royalty interest—that is, one-eighth and one-fourth of the gas produced under the 1934 and 1952 leases, respectively—so that that portion of the gas ("royalty gas") could be paid in kind to Williams for sale on the intrastate market. The authority to be sought under the Agreement would apply to sales of gas after the effective date of a Commission order granting the authority (A. 21, ¶ II-A).[5]

Pursuant to the agreement, Pennzoil and Shell moved the state court to stay their litigation pending disposition of the contemplated proceedings before the Commission (A. 23), and the state court granted the motion. When and if the Commission granted either form of relief, the parties would move to dismiss the state court action (*ibid.*). If the Commission denied both forms of relief, the parties would resume their state court litigation.

[5] In addition, ¶ II-B of the agreement (A. 21) provided that the producers would pay Williams additional royalties on volumes of gas delivered in 1974 (see A. 163-164). Shell and Pennzoil later sought Commission approval to pass through to United such retroactive payments as well (A. 163-164, 188-191). The Commission denied all the prospective relief requested and also authority to pass through the retroactive payments. See the discussion at pp. 8-10, *infra*.

As the agreement provided, Pennzoil and Shell filed petitions with the Commission seeking special relief from the area and national rates established by the Commisison to permit them to pass through to United the higher royalty rates called for in the settlement. Alternatively, they requested permission to abandon to Williams the portion of the gas produced under the leases that was attributable to Williams's royalty interests (A. 2-14).[6]

The Commission's administrative law judge, after a hearing, denied the petitions (A. 159-193). He concluded that under decisions of the Commission and the courts, exceptional relief from an area or nationwide rate established by the Commission is warranted only when a producer can demonstrate "that his overall costs incurred in the operation of the particular well or group of wells are higher than the applicable Commission-established area or nationwide ceiling rates, or, even more stringently, that his out-of-pocket expenses will exceed revenues" (A. 171). He found that Pennzoil had made no attempt to make such a showing (A. 175). He found that while Shell had made the attempt, the facts showed that at juris-

[6] United intervened in the Commission's proceeding and supported the petition by Pennzoil and Shell. United contended that the settlement was reasonable in view of the risk that the state court litigation might result in termination of the leases and thus diversion of the entire supply of gas from the interstate market (A. 52-53). United had agreed with Shell and Pennzoil to pay the higher prices called for by the settlement, "it being understood that the increases would be reflected in United's jurisdictional rates"—that is, passed on to its customers (United Br. in Opp. 3).

dictional rates Shell would still make an annual profit of more than $290,000 from its leases if it paid Williams royalties based on the 78-cent settlement figure, or an annual profit of more than $168,000 if it lost the state court litigation and paid Williams royalties based on the asserted current intrastate market price of $1.40 per Mcf (A. 178-180). The administrative law judge also denied the alternative request for the abandonment of the royalty gas, on the ground that the standards for abandonment under Section 7(b) of the Act, 15 U.S.C. 717f(b), had not been met (A. 185-188).

The Commission affirmed the decision of the administrative law judge, but on somewhat different grounds (A. 254-263; Pet. App. 14a-26a). With respect to the requested rate increase, the Commission observed that it did not have jurisdiction over the royalty owners or the royalty payments made to them by the producers,[7] and that a producer could "unilaterally" compute and pay royalties on any basis the producer chose (A. 260). The Commission held that it did have jurisdiction over the rates charged by the producer to an interstate pipeline, but that it would be inconsistent with its statutory mandate to permit the pass-through of costs based on the unregulated market price of gas (*ibid.*). The Commission stated (A. 261):

> In the instant proceeding, the impetus of the settlement is the market value of the royalties

[7] Citing *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F.2d 256 (C.A. D.C.), certiorari denied, 406 U.S. 976 (A. 260).

> and no consideration has been given to regulated rates. As such, we cannot permit any incremental royalty costs resulting from this settlement, or resulting from any judgment by a state court regarding royalty payments, to be passed on to the pipeline if these incremental royalty costs are based on any other factors than the regulated just and reasonable rate. On this point, we note the Supreme Court's warning in *FPC* v. *Texaco* [417 U.S. 380] that the Commission is not free to equate just and reasonable rates with the prices for gas in the marketplace. Accordingly, we believe that we are not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates. A contrary result would not ". . . afford consumers a complete, permanent, and effective bond of protection from excessive rates and charges" [quoting from *Atlantic Refining Company* v. *Public Service Commission*, 360 U.S. 378, 388].

Having concluded that to grant the price increase based on the unregulated rate would be at odds with the purpose of the Act, the Commission did not address the administrative law judge's determinations that Shell and Pennzoil had not demonstrated sufficient economic hardship to warrant relief from an area rate under the traditional Commission standards.

The Commission also concluded that abandonment of the royalty gas to Williams should not be authorized under Section 7(b) (A. 261-263). The Commission found that the supply of natural gas in the leaseholds was not so depleted as to warrant cessation of service, and that the public convenience and necessity

would not be served by granting an abandonment authorization that would "likely result in the subject gas being diverted from the interstate market to the intrastate market" (A. 262). The Commission rejected the argument of Pennzoil and Shell that abandonment of royalty gas would be in the public interest because otherwise Williams would cancel the leases, which would result in losing all of the gas to the intrastate market instead of only the royalty gas. The Commission held that Williams could not unilaterally terminate deliveries to United if it terminated the leases (A. 262). Relying on its decision in *El Paso Natural Gas Co.*, 54 F.P.C. 145, affirmed *sub nom. California* v. *Southland Royalty Co.*, No. 76-1587, decided May 31, 1978, the Commission stated (A. 262):

> If the lease were cancelled and Williams were to undertake to sell the subject gas, Williams would simply assume the obligations of Pennzoil and Shell to continue service to United.

The Commission subsequently denied petitions for rehearing (A. 290-295; Pet. App. 27a-33a). It reaffirmed the reasoning of its initial opinion and rejected contentions that this Court's decision in *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S 283, established the authority of the Commission to allow royalty costs based on market value to be passed on to pipelines. The Commission stated that "[w]hile indicating that relief on some grounds may be possible, [*Mobil*] does not state under what conditions relief should be granted, nor does it define when the right to gain relief matures" (A. 291).

The court of appeals reversed the Commission's orders (Pet. App. 1a-9a). The court viewed the *Texaco* case (417 U.S. 380), on which the Commission had relied, as inapplicable (Pet. App. 6a). The court held that, since Commission rate regulation is cost-based, and "[o]ne of the components of a producer's costs is clearly its royalty expense" (*ibid.*), the Commission had erred in determining that it was not permitted to pass through to interstate customers the cost to lessee/producers of royalty payments based on intrastate market value. The court relied on this Court's decision in *Mobil Oil Corp.* v. *Federal Power Commission*, *supra*, for the proposition that producers are entitled to special relief from the Commission if their royalty costs, reasonably incurred, are higher than those provided for by the applicable area or national rate established by the Commission (*id.* at 7a-8a). The court observed that "[i]n all probability, the reasonableness of a great many costs of gas production must be determined by the prevailing market price in an uncontrolled market," and said the Commission had failed to explain "why royalty costs in an uncontrolled market are any different from any other cost" (*id.* at 7a).

On the issue of alternative relief, the court directed the Commission to reconsider its decision not to permit abandonment of the royalty portion of the gas. Relying on its decision in *Southland Royalty Co.* v. *Federal Power Commission*, 543 F.2d 1134 (C.A. 5), subsequently reversed in *California* v. *Southland Royalty Co.*, No. 76-1114, decided May 31, 1978,

the court held that the Commission had been wrong in thinking that the gas from the leaseholds "was trapped in the interstate market, whether or not the leases were terminated" (Pet. App. 9a).[8]

SUMMARY OF ARGUMENT

I

A. Basic principles of rate regulation under the Natural Gas Act prohibit the Commission from authorizing a rate increase above the applicable area or national rate to accommodate a producer's royalty cost that is tied to the unregulated intrastate market in natural gas. The Commission's responsibility under Section 4(a) of the Act is to set "just and reasonable" rates for interstate sales of natural gas. Several relevant principles, approved by this Court, govern the Commission's exercise of that responsibility. First, the Commission is not required to set rates with reference to each producer's particular costs, but may set rates on an area-wide or nationwide basis. Second, the Commission is not required to consider costs that are unreasonable. Third, the

[8] On the Commission's limited petition for rehearing, the court deleted from its opinion the final statement:

> It may well be that the "present or future public convenience or necessity" will suggest the propriety of abandoning a fraction of the gas in Williams' property, rather than lose the entire amount from the interstate market. This decision is for the Commission.

The court explained: "We agree with the Commission that the statement was premature, if construed to be decisional, and unnecessary with respect to our decision" (Pet. App. 13a).

Commission should not set rates on the basis of costs that arise from contract clauses providing for indefinite price escalations or that are otherwise unrelated to the circumstances or the economics of the particular operation. Fourth, as this Court held in *Federal Power Commission* v. *Texaco*, 417 U.S. 380, the Commission may not establish rates on the basis of the unregulated market price of natural gas. The foregoing principles, particularly those set forth in *Texaco*, establish that the Commission has no authority to permit rate increases based on royalty costs tied to the unregulated market for natural gas.

B. The court of appeals, in holding that the Commission had the authority to pass through such royalty costs, did not expressly hold that the Commission was required to do so. But the rationale and the necessary implications of the court's holding would effectively compel that result in many cases. The court's decision would thus significantly impair the Commission's ability to establish just and reasonable rates.

The court's decision was based on its view that producers are entitled to individualized rate relief when, as the court thought to be true of Shell and Pennzoil, they are placed by their royalty obligations in a financial bind that reduces the funds otherwise available to them for exploration and development. The decision seems thus to establish a presumption that such relief must be granted unless exceptional circumstances are present. At best, the decision would require the Commission to review the circumstances

of each case to determine, for example, the reasonableness of the producer's having incurred particular royalty costs tied to the unregulated market. The Commission would be prohibited from excluding such costs generically on the ground that their inclusion would be inconsistent with the basic purpose of the Act.

C. The arguments advanced by respondents and the court of appeals do not support the court's decision.

1. Contrary to respondents' assertion, the royalty costs in this case are based on the unregulated market. Although those costs are presently embodied in a settlement agreement, the settlement reflects the claim being settled—a claim for royalties based on the unregulated market. As the Commission held, the only reason Shell and Pennzoil agreed to pay royalties higher than they had been paying was the claim made against them in state court for royalties based on the unregulated market.

2. As *Texaco* indicates, it is immaterial that royalty costs are only one component of the producers' costs, or that they do not equal the unregulated price of gas, but are only a percentage of that price. Whatever the size of the cost component, the Act does not permit this method of calculating just and reasonable rates.

3. Contrary to the court of appeals' view, royalty costs based on the price of natural gas in the unregulated market are not the same as other costs of production that may properly be determined by reference to unregulated markets. The critical difference

is that the royalty costs at issue here are tied to the unregulated price for the very commodity whose price the Commission is charged with regulating.

4. The court of appeals also erred in concluding that *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283, holds or suggests that the Commission has authority to grant the rate increases requested by Shell and Pennzoil here. In *Mobil*, this Court viewed as hypothetical, and therefore declined to rule on, a producer's claim that the Commission, in an area rate proceeding, had failed to provide for future increases in royalty costs. In stating that producers oppressed by individual costs might seek individualized relief, the Court indicated nothing about the circumstances in which such relief might be appropriate.

In fact, it is well-established that the Commission will not authorize special relief from an area rate unless a producer can show that its costs exceed its revenues at that rate—a showing neither Shell nor Pennzoil could make in this case. The court of appeals therefore erred in concluding that, because Shell and Pennzoil may face increased royalty costs from state court judgments that would "absorb funds otherwise available for exploration and development" (Pet. App. 8a), the Commission was required to consider their requests for special relief.

II

The Commission properly denied the alternative request of Shell and Pennzoil to allow abandonment of "royalty gas" from the leaseholds so that it could

be paid "in kind" to the lessor for sale on the intrastate market. The contrary determination of the court of appeals was based on its decision in *Southland Royalty Co.* v. *Federal Power Commission*, 543 F.2d 1134, which this Court later reversed in *California* v. *Southland Royalty Co.*, No. 76-1114, decided May 31, 1978. This Court's decision establishes that the Commission was correct and the court of appeals in error.

ARGUMENT

I. UNDER THE NATURAL GAS ACT THE COMMISSION MAY NOT AUTHORIZE PRODUCERS TO PASS THROUGH TO INTERSTATE CONSUMERS ROYALTY COSTS BASED ON THE UNREGULATED INTRASTATE PRICE OF NATURAL GAS

The court of appeals held that the Commission has authority under the Natural Gas Act to permit producers to pass through to pipelines, and hence to interstate consumers, royalty costs based on the unregulated price of natural gas in the intrastate market. We will show that (A) the decision is contrary to basic principles of rate regulation established by the Act and by decisions of this Court; (B) although the court did not expressly hold that the Commission was required to permit the pass-through of such royalty costs, its holding that the Commission has the authority to do so, and the rationale for that holding, would significantly impair the Commission's ability to fulfill its statutory mandate of ensuring just and reasonable rates; and (C) the reasons offered by the

court and respondents in support of the decision are unpersuasive.[9]

A. Basic Principles of Rate Regulation Establish That The Commission Has No Authority to Permit Producers to Pass Through Royalty Costs Based On The Unregulated Market Price of Natural Gas

Section 4(a) of the Natural Gas Act, 15 U.S.C. 717c(a), requires the Commission to ensure that all rates charged for the transportation or sale of natural gas subject to the Commission's jurisdiction are "just and reasonable." As a general matter, the Commission, like most rate-regulating bodies, establishes rates on the basis of the seller's costs plus a reasonable rate of return. See *Permian Basin Area Rate Cases*, 390 U.S. 747, 756-762. Several other well-settled principles, however, also govern the Commission's rate-setting responsibilities under the Act.

First, the Commission has authority to establish the maximum rates producers may charge on an area-wide or nation-wide basis, and is not required to promulgate an individual rate for each producer on the basis of his own particular costs. *Permian Basin Area Rate Cases, supra; Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283. In recent years, the Commission has in fact promulgated rates on an

[9] Congress is presently considering a bill entitled The Natural Gas Policy Act of 1978, H.R. 5289, 95th Cong., 2d Sess. (1978). On August 18, 1978, a conference committee report was issued on the bill reflecting agreement on the part of the managers of the House and Senate. S. Rep. No. 95-1126, 95th Cong., 2d Sess. To the extent that future legislature appears to affect the issues in this case, we will advise the Court in a supplemental memorandum.

area-wide or nation-wide basis.[10] While the Commission may grant special rate adjustments or other relief to a producer in exceptional circumstances, it is not required to do so merely because the producer's own costs exceed the area or national average. *Permian, supra*, 390 U.S. at 770-772. As this Court said in *Federal Power Commission* v. *Texaco*, 417 U.S. 380, 387: "That every rate of every natural gas company must be just and reasonable does not require that the cost of each company be ascertained and its rates fixed with respect to its own costs."

Second, the fact that one or even all producers incur a particular cost does not require the Commission to include all of that cost in the rate base if it is excessive or unreasonable. If, for example, a producer or group of producers were paying a price for drilling material that was twice the price reasonably available from other suppliers, or were using platinum instead of steel pipe, the Commission would not be required to pass those costs on to interstate pipelines, and hence to interstate consumers, as part of the jurisdictional rate. See *Permian, supra*, 390 U.S. at 824-825, n. 115; *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F.2d 256, 263 (C.A. D.C.), certiorari denied, 406 U.S. 976. Rather the Commission's responsibilities under the Act are "so framed as to afford *consumers* a complete, permanent and

[10] See, *e.g.*, *Permian, supra* (upholding area rates); *Shell Oil Co.* v. *Federal Power Commission*, 520 F.2d 1061 (C.A. 5), certiorari denied, 426 U.S. 941 (upholding national rates).

effective bond of protection from excessive rates and charges." *Atlantic Refining Co.* v. *Public Service Commission*, 360 U.S. 378, 388 (emphasis supplied).

Third, in accord with its responsibility to ensure that rates are reasonable, the Commission may refuse to establish rates that reflect contract clauses providing for indefinite price escalations. In *Permian* this Court affirmed the Commission's refusal to permit rate increases based on such clauses, citing the Commission's statement that to allow the increases would not be "in accordance with the principles upon which a rate structure should be based" and would be "incompatible with the public interest." 390 U.S. at 782-783 (quoting from the Commission's orders in 34 F.P.C. 159, 236 and 25 F.P.C. 379, 380). That is so because the escalation clauses "cause price increases * * * to occur without reference to the circumstances or economics of the particular operation, but solely because of what happens under another contract." 34 F.P.C. at 373; 390 U.S. at 782-783. See also *Federal Power Commission* v. *Texaco, Inc.*, 377 U.S. 33, 42.

Fourth, the Commission is not permitted by the Act to establish regulated rates on the basis of the unregulated market price of natural gas. To do so is inconsistent with the very notion of rate regulation, and this Court expressly so held in *Federal Power Commission* v. *Texaco*, 417 U.S. 380. In that case the Commission sought by rule to exempt small jurisdictional producers from most of the regulatory requirements of the Act, including individual certification, filing of rate increases, and refund obligations. The

Commission sought to regulate the rates of the small producers only indirectly, through its regulation of large producers and pipelines who purchased gas from the small producers and whose costs therefore reflected the prices paid to the small producers.

The Court rejected the Commission's rule. The Court noted that the rule appeared to permit the large producers and pipelines to pass through automatically the unregulated prices they paid to the small producers, and that "the implication appears to be that reasonableness would be judged by the standard of the marketplace" (417 U.S. at 396). The Court stated (*id.* at 397-399):

> [W]e should also stress that in our view the prevailing price in the marketplace cannot be the final measure of "just and reasonable" rates mandated by the Act. It is abundantly clear from the history of the Act and from the events that prompted its adoption that Congress considered that the natural gas industry was heavily concentrated and that monopolistic forces were distorting the market price for natural gas. * * * In subjecting producers to regulation because of anti-competive conditions in the industry, Congress could not have assumed that "just and reasonable" rates could conclusively be determined by reference to market price. Our holding in *Phillips* [347 U.S. 672] implies just the opposite. * * * [Footnote omitted].

See also *Federal Power Commission* v. *Sunray DX Oil Co.*, 391 U.S. 9, 25-26, where the Court specifically rejected the contention that prevailing market prices —in the form of contemporaneous contract prices—

could be equated with "just and reasonable" rates under the Act.

The court of appeals' decision is contrary to the foregoing principles, and particularly to those set forth in *Texaco*. Shell and Pennzoil have requested the Commission to approve an increase in their jurisdictional rates that would be based on the price of gas in the unregulated market. That increase, and hence a significant part of the entire rate, would "conclusively be determined by reference to market price" (*Texaco, supra*, 417 U.S. at 399).[11]

Furthermore, if the Commission permitted a rate increase based on the unregulated market price, jurisdictional rates would be subject to unpredictable fluctuations and escalations that are beyond the control of the Commission, are unrelated to "the circumstances or economics of the particular operation," and are solely a function of "what happens under [o]ther contract[s]." *Permian, supra*, 390 U.S. at 782-783. In this case, for example, Williams claimed that Pennzoil and Shell owed royalties on the basis of market prices ranging from $.35 per Mcf in 1971 (A. 115) to $1.40 per Mcf in 1975 (A. 119-121). Market prices will no doubt continue to fluctuate, and probably to escalate if present trends continue. No less than in *Permian*, to permit increases in juris-

[11] This is so notwithstanding the settlement and the use of the royalty figures set forth in that settlement; the settlement reflected the claim being settled, and that claim was for "market value" royalties determined by the intrastate market. See pp. 26-27, *infra*.

dictional rates on the basis of such unpredictable market fluctuations would be inconsistent " 'with the principles upon which a rate structure should be based.' " 390 U.S. at 782.[12]

B. The Court of Appeals' Decision Would Significantly Impair the Commission's Ability to Ensure Just and Reasonable Rates

As we have shown, the court of appeals disregarded basic regulatory principles in holding that the Commission has authority to permit producers to pass through royalty costs based on the price of gas in the unregulated market.[13] The court, however, did

[12] Moreover, from the standpoint of the interstate consumers for whose protection the Act was passed *(Atlantic Refining Co.* v. *Public Service Commission, supra)*, the circumstances of this case provide no reason for permitting Shell and Pennzoil to increase their rates in response to their lessor's demands for higher royalty rates. As discussed *infra*, pp. 37-41 and note 24, this Court's decision in *California* v. *Southland Royalty Co.*, No. 76-1114, decided May 31, 1978, establishes that the lessor, if he terminated the leases, would be required to continue the interstate service at applicable Commission rates. Thus there is no reason to impose a higher rate on interstate consumers merely because of the private contractual arrangements between the parties in this case.

[13] While the basic scheme of the Act prohibits the Commission from allowing the pass-through of such costs, the prohibition has practical significance only when, as in this case, a producer seeks Commission authorization for a rate higher than the applicable area or national rate. The Commission's area and national rates are ceilings; nothing bars a producer from charging a lower rate. If the Commission establishes a just and reasonable ceiling rate on the basis of factors unrelated to the price of gas in the intrastate market, and a particular producer has a royalty cost that is based on the intra-

not expressly *require* the Commission to permit the pass-through of such costs. It might be suggested, then, that the Commission can still refuse to grant such permission, in which case the court's decision, however erroneous, might not be particularly significant. The necessary implications of the court's decision, however, would compel the Commission to permit such pass-throughs in many, if not most cases, and thus to increase rates on the basis of an illegal factor. The decision would thus seriously impair the Commission's ability to ensure just and reasonable rates.

The court's decision would in practice affect the level of just and reasonable rates in several ways. First, the Commission, as we have noted (pp. 17-18, *supra*), is not required to calculate its rates with reference to each producer's particular costs, but may use area or national averages. In individual cases, the Commission might be justified in declining to permit the pass-through of "market value" royalty costs even if it had the authority to grant such permission. But if many producers incur a significant cost that the courts hold to be properly includable in the rate base, as the court of appeals has effectively held here, that

state market price, there is nothing that prevents that producer from paying that cost and reflecting it in his rate, so long as the rate he charges does not exceed the Commission's ceiling. What the Act prohibits is the Commission's establishment of ceiling rates based on the price of natural gas in the intrastate market, or, as is proposed in this case, the Commission's authorizing a particular producer to charge a rate in excess of the applicable ceiling because of costs pegged to the price of gas in the intrastate market.

cost will affect the average. The number of "market value" royalty provisions in gas leases, together with the substantial cost impact of such provisions if they are held to refer to the intrastate market, may well produce such an effect.[14]

More important, even if the costs in question here were incurred by only a few producers, it is doubtful that, under the court's rationale, the Commission would be justified in denying individualized rate relief to those producers. For the court's conclusion was based, at least in part, on its view that Shell and Pennzoil would be " 'put in a bind by their royalty obligations' " if they lost the state court litigation, and on the court's apparent view that this Court's decision in *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283, requires the Commission to provide individualized relief to producers in such circumstances (Pet. App. 8a). At the least, therefore, the decision appears to establish a heavy presumption that individual relief must be granted to such producers, and would preclude the Commission from denying relief on the basis of its view that rate increases based on the price of gas in the unregulated market are inconsistent with the purpose of the Act.

[14] As noted earlier (p. 5, note 4, *supra*), the Commission does not have information concerning the number of leases containing "market value" royalty provisions or the amounts of gas underlying such leases, but the volume of pending litigation over such provisions suggests that their impact (if interpreted to refer to the intrastate market) would be significant.

In some cases the Commission might conclude that a given producer had been unreasonable in incurring royalty costs based on the intrastate market price. Under the court's rationale, however, the Commission plainly could not conclude that incurring such costs was unreasonable *per se*. And if the court is correct that under the scheme of the Act such costs may properly be included in the rate base for Commission-established rates, it is difficult to see what circumstances would justify a conclusion that incurring the costs was unreasonable.

In short, the court of appeals' decision, at best, would require the Commission to review the circumstances of each case to determine whether particular royalty costs based on the intrastate market for natural gas were or were not permissible for individualized reasons. The decision would prohibit the Commission from excluding such costs generically on the ground that their inclusion would undermine the purpose of the Act. The likely consequence of the decision would be to establish a strong presumption that such costs must be included, and that petitions such as that of Shell and Pennzoil must be granted by the Commission in the absence of exceptional circumstances.

C. **The Arguments Advanced by Respondents And The Court of Appeals Do Not Support The Court's Decision**

1. ***The Increased Royalty Costs That Shell and Pennzoil Seek to Pass Through Are Based on The Unregulated Market Price***

Respondents Pennzoil and Shell have argued that the increased royalty costs they seek to pass through to interstate consumers are not based on the intrastate market price but on prices agreed to by Shell, Pennzoil, and Williams as part of their settlement.[15] The argument ignores the realities of the situation and was properly rejected by the Commission.[16]

The cause of the settlement was the claim being settled: the claim by Williams that Shell and Pennzoil owed it royalties based on the intrastate market price. Shell and Pennzoil have never suggested any other reason for agreeing to pay royalties substantially higher than they had been paying for years. Thus the Commission correctly observed (A. 261) that "the impetus of the settlement is the market value of the royalties and no consideration has been given to regulated rates."

If we are correct that passing through royalty costs based on the intrastate market price of gas offends the basic scheme of the Act, private litigants can-

[15] Pennzoil Br. in Opp. 9; Shell Br. in Opp. 3, n. 3.

[16] The court of appeals did not address this argument but implicitly rejected it, since its opinion addressed the merits of the Commission's position that it had no authority to pass through royalty costs based on the intrastate market price.

not make such a result acceptable by agreeing on royalty costs that are somewhat less than the royalty owner's original "market value" claim.[17]

2. ***The Fact that "Market Value" Royalty Costs Are Only Part of the Producers' Total Costs Does Not Provide a Basis for Distinguishing This Court's Decision in* Federal Power Commission *v.* Texaco, Inc., *417 U.S. 380***

The court of appeals stated that this Court's decision in *Texaco, supra,* was "inapplicable to the instant case" (Pet. App. 6a). The court gave little indication of its reasons.[18] But they appear to be based on the view, amplified in the arguments of respondents,[19] that the jurisdictional rate considered in *Texaco* was determined solely by reference to the unregulated market price, whereas in this case only one component of the producers' cost would be determined by reference to the unregulated market price.

The claim is factually incorrect. The cost at issue in *Texaco* was the price the regulated producers paid

[17] See *Texaco, supra,* 417 U.S. at 399.

[18] The court said that "[t]his case deals with royalty cost under specific leases" (*ibid.*). But that scarcely distinguishes *Texaco,* where, as the court recognized, this Court "held that the final measure of 'just and reasonable' rates, mandated by sections 4 and 5 of the Act, could not be the prevailing price in the unregulated marketplace" (*ibid.*). Nothing in the Act suggests—and the court did not claim—that rates for the interstate sale of gas "under specific leases" need not be "just and reasonable."

[19] Pennzoil Br. in Opp. 10; Shell Br. in Opp. 2-3.

for gas purchased from the small producers. Like the cost at issue here, it was only one component of the total costs of the regulated producers. Under the Commission's plan in *Texaco,* that component would have been included with all the other costs of the regulated producers to determine their jurisdictional cost base.

More important, as *Texaco* itself indicates, the fact that royalty costs are only one of several components of the producers' costs is immaterial. They are a significant component, and the principles reaffirmed in *Texaco* do not suggest that a part of the interstate rate approved by the Commission may be based solely on the unregulated market so long as the whole rate is not determined on that basis. As this Court stated, "the Act makes unlawful all rates which are not just and reasonable, and does not say a little unlawfulness is permitted" (417 U.S. at 399).

Nor does the particular ratio between the royalty cost and the unregulated price make a legal difference. The ratios here are substantial—one-eighth and one-fourth—but in any event the court of appeals' rationale would apply if the leases provided for royalties equalling 90 percent of the "market value," thus resulting in jurisdictional rates approaching parity with the unregulated market. Whether the cost component that is determined by reference to the unregulated market is large or small, the Act does not permit the Commissioner to calculate just and reasonable rates by that method.

3. *The Fact That "Market Value" Royalties Are Costs Actually Paid by the Producers Does Not Authorize or Require the Commission to Permit Them To Be Passed Through to Interstate Consumers*

The court of appeals stated, and respondents have argued,[20] that royalty costs are no different from any other cost of production and therefore, under "a cost plus profit approach to gas rate regulation" (Pet. App. 6a), should be included in the rate base if they are reasonable. As the court stated (Pet. App. 7a):

> Determination of the reasonableness of a cost necessarily requires consideration of market price. In all probability, the reasonableness of a great many costs of gas production must be determined by the prevailing market price in an uncontrolled market. The Commission has failed to suggest why royalty costs in an uncontrolled market are any different from any other cost.

The difference is plain. The royalty costs at issue here are pegged to the unregulated market price of the very commodity whose interstate price the Commission is charged with regulating. In contrast to the costs of labor, steel, or other elements of production whose price the Commission has no responsibility for regulating, royalty costs based on the unregulated price of natural gas would undermine the premise of price regulation of natural gas. To allow the pass-through of such costs would be to ignore the Act's objective of "afford[ing] consumers a complete,

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[20] Pennzoil Br. in Opp. 9-10; Shell Br. in Opp. 2-3.

permanent and effective bond of protection from excessive rates and charges" (*Atlantic Refining Co.* v. *Public Service Commission, supra*, 360 U.S. at 388), by spiriting into the just and reasonable rates mandated by the Act the very unregulated rates and charges against which protection was sought. See also, *e.g.*, *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 682-684.[21]

4. *This Court's Decision in* Mobil Oil Corp. *v.* Federal Power Commission, *417 U.S. 283, Does Not Support the Decision of the Court of Appeals*

The court of appeals relied on this Court's decision in *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283, affirming *Placid Oil Co.* v. *Federal Power Commission*, 483 F.2d 880 (C.A. 5), for its conclusion that the Commission has authority, if not an obligation, to permit the pass-through of "market value" royalty costs. The court of appeals reasoned that because the state courts may ultimately determine that the "market price" clauses of the Williams leases refer to the intrastate market, Shell and Pennzoil have been "put in a bind" between the jurisdictional rate and their royalty obligations—a situation in which they face either termination of their leases or "increased royalty payments, which would absorb funds otherwise available for exploration and development" (Pet. App. 8a). The court concluded that *Mobil* requires the Commission at least to consider, and apparently to grant, individualized relief to producers placed in such a bind (*ibid*; see p. 24, *supra*).

[21] Moreover, contrary to the court of appeals' suggestion, the Commission would not necessarily be required to include in the rate base other costs of production that were tied by agreement to fluctuations in an unregulated market. Prevailing market prices for, say, steel or labor may be taken into consideration when the Commission establishes jurisdictional rates. But if a producer entered into a long-term labor or materials contract that fixed his price of labor or materials on some imprudent basis and not as a function of local conditions or the circumstances of the particular operation, it would be open to the Commission to determine that the future pass-through of such costs is unreasonable and not " 'in accordance with the principles upon which a rate structure should be based.' " *Permian, supra*, 390 U.S. at 782.

Mobil imposes no such requirement. Nor does the alleged bind in which Shell and Pennzoil have been placed, or will be placed, warrant any departure from the basic principles of rate regulation under the Act.

a. In *Mobil* the court of appeals and this Court upheld an area rate promulgated by the Commission. One of the many objections considered by the Commission and the courts was Mobil's complaint that the Commission had failed to provide for automatic rate adjustments to accommodate anticipated increased royalty costs. The Commission found the issue to be premature in the context of the area rate proceeding. The court of appeals agreed, stating (483 F.2d at 911; emphasis in original):

> [W]e are not willing to alter or stay the implementation of area wide rates for the entire industry merely on the basis of what *might* happen to *some* producers' costs *if* this statement of the law prevails.
>
> If, as subsequent events develop, the producers are put in a bind by their royalty obligations,

> they may certainly petition FPC for individualized relief. * * * [W]e find it to be far preferable to speculative prophesies of future royalty components. If the royalty obligations are such as to make the rates established by [the Commission's decision] and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will certainly have recourse to the administrative process. * * *

This Court "agree[d] with the Court of Appeals that Mobil's argument is hypothetical at this stage and that in any event an affected producer is entitled to seek individualized relief" (417 U.S. at 328). In making that observation the Court recognized that the Commission may grant special relief in some instances where actual costs are higher than those provided for in the area rate. It did not discuss or determine what those instances might be, or what kinds of royalty obligations might make the established rates, in the words of the court of appeals, "confiscatory or otherwise inappropriate." In particular, the Court did not consider whether the Commission either could or must grant relief for royalty obligations tied to the unregulated price of gas in the intrastate market.

b. When that question is considered, the "bind" that Shell, Pennzoil, and other producers may face would warrant no such relief. That bind would result from two rulings. On the one hand, the Court of Appeals for the District of Columbia held in *Mobil Oil Corp.* v. *Federal Power Commission*, 463

F.2d 256, certiorari denied, 406 U.S. 976, that lessors (or "royalty owners") are not natural-gas companies under the Act and hence that the Commission lacks jurisdiction over the terms of lease agreements, including royalty provisions. On the other hand, some state courts have held, and others may, that "market value" or "market price" royalty clauses refer to the unregulated intrastate market. See, p. 5, note 4 *supra*.

Even if both rulings are correct (but see the discussion at pp. 35-37, *infra*), they do not warrant the relief requested by respondents. If we assume that a lessor may charge a lessee/producer any royalty the latter is willing to pay, it does not follow that the Commission is authorized or required to pass all of that royalty on to interstate customers. In *Permian* this Court established that neither the Constitution nor the Natural Gas Act is offended by a rate structure that denies full recovery of all costs to some producers. "No constitutional objection arises from the imposition of maximum prices merely because 'high cost operators may be more seriously affected * * * than others,' *Bowles* v. *Willingham* [321 U.S. 503, 518], or because the value of regulated property is reduced as a consequence of regulation" (390 U.S. at 769). The Court upheld in that case the Commission's policy that, while it might grant relief from the area rate in some circumstances, "a producer's inability to recover either its unsuccessful exploration costs or the full 12% return on its production investment would not, without more, warrant relief,"

and that "the burden would be upon the producer to establish the propriety of an exception * * *" (390 U.S. at 771).

In accordance with those principles, the Commission, with the approval of the courts, has established the policy that it will not authorize departures from area rates unless a producer can show that its costs exceed its revenues at the area rate. See, *e.g.*, Opinion No. 699, 51 F.P.C. 2212, 2279, affirmed, *Shell Oil Co.* v. *Federal Power Commission*, 520 F.2d 1061 (C.A. 5), certiorari denied, 426 U.S. 941. In the present case the administrative law judge denied relief on the ground that Shell and Pennzoil had made no such showing, and that Shell at least would still derive a substantial profit from its lease even if it paid the higher royalties (see pp. 7-8, *supra*).

The Commission, without rejecting these findings, denied relief on grounds more fundamental to the scheme of the Act, and we are not suggesting that the Commission be affirmed on grounds that it did not itself rely on. We do contend, however, that the court of appeals erred in holding that the Commission was authorized, if not required, to grant relief because the producers faced a financial bind resulting from "increased royalty payments, which would absorb funds otherwise available for exploration and development" (Pet. App. 8a). Even if a particular producer's costs would "absorb funds otherwise available" for those uses, that in itself is not a ground for relief from an area rate.

c. In any event, the "bind" asserted by Shell and Pennzoil, and relied on by the court of appeals, cannot at this point be assumed to exist. The state courts of Louisiana have not determined whether the leases require royalties based on intrastate market prices or on the regulated prices at which the gas is actually sold. As noted earlier (p. 5, note 4, *supra*), that issue has been addressed in only a few reported cases, and those courts are divided. In this case the administrative law judge, noting that "the dire results envisaged by Pennzoil and Shell from the state court litigation are, of course, speculative," expressed the view that "[i]t is highly doubtful that Williams would prevail on its claim that 'market value' for basing royalty payments means a price in excess of the Commission-established area and nationwide ceiling prices" (A. 182).

While we express no view on the likely outcome of the state court litigation, we do believe that the administrative law judge was correct in concluding that "market value" royalty clauses, properly construed, refer to the market in which the parties contemplated that the gas would be sold—in this case, the regulated interstate market. See A.182-183; see also *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F.2d 256, 265 (C.A. D.C.), certiorari denied, 406 U.S. 976.

We also believe that when such clauses apply to sales within the jurisdiction of the Commission, the question is one of federal law. When the Commission establishes jurisdictional rates, it properly takes

into account the funds needed by jurisdictional producers for exploration and development, as well as the fair rate of return. Although an individual producer has no entitlement to rate relief on the ground that his own costs deprive him of funds that the Commission anticipates will be available to the average producer, at the same time state courts cannot impair the Commission's ability to carry out its responsibilities under the Act. When state courts, on the basis of state law, impose on jurisdictional producers a cost that the Commission is precluded by the Act from including in jurisdictional rates, they undermine the purposes and impair the effectiveness of the federal statute. Cf. *Northern Natural Gas Co.* v. *State Corporation Commission of Kansas*, 372 U.S. 84, 91.

We have expressed these views in our memorandum supporting the petition for rehearing of the denial of certiorari in *Mobil Oil Corp.* v. *Lightcap*, No. 76-1694, where "market value" royalty clauses were held to refer to the unregulated market. The resolution of the present case does not turn on the resolution of the issue in *Lightcap*; even if the producer's royalty obligation is measured by the unregulated market, the Commission cannot pass through such increased costs to the interstate consumer. Nevertheless, the issues are plainly related. A judicial rejection of the view that "market value" royalty clauses refer to the intrastate market, where sales were contemplated and are actually being made in the interstate market, would obviate the "bind" that respond-

ents assert and would promote the regulatory purposes of the Act.[22]

II. THE COMMISSION PROPERLY DENIED THE REQUEST TO ALLOW ABANDONMENT OF ROYALTY VOLUMES OF GAS DEDICATED TO INTERSTATE COMMERCE

As an alternative to the requested price relief, Shell and Pennzoil petitioned the Commission to authorize abandonment, pursuant to Section 7(b) of the Act, 15 U.S.C. 717f(b), of portions of the leasehold gas attributable to Williams' royalty interest (that is, one-eighth and one-fourth of the gas produced under the 1934 and 1952 leases, respectively), so that Williams

[22] In our petition for a writ of certiorari in this case we suggested that another alternative would be reconsideration of the decision of the District of Columbia Circuit in *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F.2d 256, certiorari denied, 406 U.S. 976, holding that the Commission has no jurisdiction over royalty payments under leases because lessors are not natural gas companies within the meaning of the Act. On further consideration, we do not press that suggestion here. For one thing, the Commission in its opinion accepted the D.C. Circuit's decision in *Mobil* and stated that lessors and lessee/producers could unilaterally charge and pay any royalty they desired, so long as it was not passed through to interstate customers (A. 260; Pet. App. 21a-22a). See *Burlington Truck Lines* v. *United States*, 371 U.S. 156, 168-169. But see *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672. Further, the purposes of the Act would not require a conclusion contrary to that of the court of appeals in *Mobil* if we are correct in our position that costs calculated on the basis of the unregulated market cannot be included in regulated rates, and in our position that federal law requires that "market value" royalty clauses affecting jurisdictional sales be construed as referring to the regulated rate.

could take this "royalty gas" in kind and dispose of it in the intrastate market (see pp. 6-7, *supra*). Section 7(b) provides:

> No natural-gas company shall abandon * * * [any facilities or any service subject to the jurisdiction of the Commission] without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

Shell and Pennzoil argued to the Commission that the public interest would be served by authorization to abandon the royalty gas, because otherwise the leases might be cancelled and all of the gas, not just the royalty portion, diverted from the interstate market.[23] The Commission found this fear unwarranted (A. 262):

> [W]e do not share the concern * * * that Williams could terminate deliveries to United even if the leases were cancelled as a result of state court litigation. If the lease were cancelled and Williams were to undertake to sell the subject gas, Williams would simply assume the obligations of Pennzoil and Shell to continue service to United.

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[23] It was undisputed that the available supply of gas underlying the leased lands was not depleted, so that abandonment could not be permitted on that basis (see A. 186, n. 15).

The Commission concluded that diversion of the royalty gas from the interstate market would not serve the public convenience and necessity, and the abandonment request was accordingly denied (A. 263).

The court of appeals remanded the issue to the Commission for reconsideration in light of the court's then-recent decision in *Southland Royalty Co.* v. *Federal Power Commission*, 543 F.2d 1134 (C.A. 5), reversed *sub nom. California* v. *Southland Royalty Co.*, No. 76-1114, decided May 31, 1978. The court held that the Commission "was acting under the wrong legal premise" in denying abandonment—that is, "the Commission was under the impression that Williams' gas was trapped in the interstate market, whether or not the leases were terminated" (Pet. App. 9a).

This Court's decision in *Southland Royalty* establishes that the Commission was correct and the court of appeals in error. The Court held that the expiration of a lease does not affect the obligation to continue the interstate service from the leased acreage, unless the Commission authorized abandonment:

> This issuance of a certificate of unlimited duration covering the gas at issue here created a federal obligation to serve the interstate market until abandonment had been obtained. The Commission reasonably concluded that under the statute the obligation to continue service attached to the gas, not as a matter of contract but as a matter of law, and bound all those with dominion and

power of sale over the gas, including the lessor to whom it reverted. [Slip op. 6.]

Southland Royalty involved a 50-year lease that terminated automatically by the passage of time. The Court's decision there applies at least as strongly to the situation posited here, which would be the unilateral termination of a lease by the lessor prior to its specified term. There is, indeed, even less basis for the claim that interstate service may be abandoned, without the Commission's approval, by a lessor who terminates a lease prematurely out of a desire to divert gas to the more lucrative intrastate market.

Thus, the Commission's reasoning that Williams would be obligated to continue the interstate service initiated by Pennzoil and Shell, even if the leases were cancelled, is squarely validated by *Southland Royalty* (slip op. 7):

> Once the gas commenced to flow into interstate commerce from the facilities used by the lessees, § 7(b) required that the Commission's permission be obtained prior to the discontinuance of "any service rendered by means of such facilities." Private contractual arrangements might shift control of the facilities and thereby determine *who* is obligated to provide that service, but the parties may not simply agree to terminate the service obligation without the Commission's permission.

Correspondingly, the court of appeals' basis for reversing the Commission's refusal here to allow abandonment of the royalty gas has been rejected. In the light of *Southland Royalty*, the court's holding on this

issue should be reversed, and the Commission's determination affirmed.[24]

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

WADE H. MCCREE, JR.,
Solicitor General.

STEPHEN R. BARNETT,
Deputy Solicitor General.

RICHARD A. ALLEN,
Assistant to the Solicitor General.

ROBERT R. NORDHAUS,
General Counsel,

HOWARD E. SHAPIRO,
Solicitor,

MCNEILL WATKINS, II,
Attorney,
Federal Energy Regulatory Commission.

SEPTEMBER 1978.

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[24] As noted *supra*, p. 22, note 12, this conclusion provides further support for the Commission's denial of the rate increases requested by Shell and Pennzoil. If Williams cancelled the leases and was required to continue the interstate service, as *Southland Royalty* held would be the case, Williams's sales in interstate commerce would be subject to the applicable Commission ceiling rates. It would be anomalous to permit Shell and Pennzoil to increase their rates above the ceiling because otherwise Williams might cancel their leases, when Williams itself could not charge a higher-than-ceiling rate if it did cancel.

APPENDIX

Section 4(a) of the Natural Gas Act, 52 Stat. 822, as amended, 15 U.S.C. 717c(a) provides:

> All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is declared to be unlawful.

Section 7(b) of the Natural Gas Act, 52 Stat. 824, 15 U.S.C. 717f(b) provides:

> No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

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IN THE

Supreme Court of The United States

OCTOBER TERM, 1978

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION,

Petitioner,

v.

PENNZOIL PRODUCING COMPANY, ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF OF PENNZOIL PRODUCING COMPANY

JOHN M. YOUNG
General Attorney
Pennzoil Producing Company
3100 Pennzoil Place
Houston, Texas 77001

JERON STEVENS
STEPHEN M. HACKERMAN
Baker & Botts
3000 One Shell Plaza
Houston, Texas 77002
(713) 229-1234

Counsel for
Pennzoil Producing Company

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IN THE

Supreme Court of The United States

OCTOBER TERM, 1978

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION,
Petitioner,

v.

PENNZOIL PRODUCING COMPANY, ET AL.,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF OF PENNZOIL PRODUCING COMPANY

OPINIONS BELOW AND JURISDICTION

The opinions below are correctly referenced and the jurisdictional prerequisites are adequately set forth in the brief of the Federal Energy Regulatory Commission (Commission).

QUESTIONS PRESENTED

1. Whether the Commission has the authority to consider and permit a natural gas company to collect a rate in excess of Commission established ceiling rates to allow recovery of a prudently incurred increased royalty cost?[1]

2. As will be discussed *infra*, Pennzoil Producing Company (Pennzoil) is unsure what question with respect to abandonment authorization under Section 7(b) of the Natural Gas Act[2] should be briefed. In its petition for certiorari, the Commission framed the question as one of authority to permit abandonment, and certiorari presumably was granted with respect to that issue. However, in its brief the Commission states the issue and argues it as a question of whether the Commission's decision regarding abandonment was correct on the merits.

STATUTES INVOLVED

The Commission's brief properly references the statutes involved.

STATEMENT

This case presents to this Court for the first time in the context of an actual controversy the question of the regulatory treatment to be accorded royalty costs incurred in connection with gas produced under "market value" royalty leases and sold subject to the jurisdiction of the Commission. The Commission's position is that it has no authority to respond to the regulatory problems created by market value royalty costs and therefore it cannot allow recovery of

[1] As we will demonstrate in the Statement portion of this brief, the Commission is factually wrong in asserting that Pennzoil's proposed rate increase is based on the "unregulated price of natural gas in the intrastate market" (Comm. Br. 2, 14, 26-27). The incremental royalty rate is based solely on a percentage of Commission established rates.

[2] 15 U.S.C. § 717f(b).

such costs. Pennzoil believes the Commission has unduly and unjustifiably restricted its authority to the detriment of both the natural gas companies it regulates and the consumers whose interests it is charged with protecting.

The facts are undisputed. Pennzoil sells to United Gas Pipe Line Company (United) gas produced from acreage leased in Louisiana from Williams, Inc., *et al.* (Williams) (A. 41-42). Because the sale is in interstate commerce for resale it is subject to the Commission's jurisdiction and the price which Pennzoil may collect is limited to the applicable ceiling prices established by the Commission. These ceiling rates apply to the royalty share of the gas as well as Pennzoil's working interest share. At the same time, however, the amount that Williams as lessor receives from Pennzoil for the sale of the royalty share is not subject to Commission jurisdiction. *Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied*, 406 U.S. 976 (1972).

The Williams lease provides for royalty payments based on one-eighth of the "market rate" of the gas (A. 133). Pennzoil is collecting the highest rates allowed by the Commission for Williams acreage gas (A. 42), an average of about 40.9¢ per Mcf at the time of the hearing in this case (A. 158), and is paying royalty based on such rates.[3]

Williams claims, however, that the "market rate" for the gas is in excess of that which the Commission has determined to be the highest rate which Pennzoil can collect. Williams' claim as to the "market rate" has steadily escalated from 70¢ per Mcf for the period November 1973 through May 1974, to $1.40 per Mcf for the period January 1975 through April 1975 (A. 114; 120; 423). These claims

[3] A portion of the gas is covered by the national rate set forth in 18 C.F.R. § 2.56b, and the rest is covered by the national rate set forth in 18 C.F.R. § 2.56a.

have been asserted by Williams in a lawsuit currently pending in a Louisiana state court.[4]

The prices upon which Williams claims royalties should be based are far in excess of the applicable ceiling rates which Pennzoil is actually collecting. Relying on cases such as *J. M. Huber Corp.* v. *Denman*, 367 F.2d 104 (5th Cir. 1966), and *Texas Oil & Gas Corp.* v. *Vela*, 429 S.W.2d 866 (Tex. 1968), Williams asserts that the basis for royalty payments under the market value royalty provision is not limited to the price actually being collected. In addition, relying on the *Mobil* determination that the Commission has no jurisdiction over royalty owners, Williams asserts that the Commission's ceiling rate does not limit the price upon which royalty payments are to be based. Williams' claim is for damages in excess of $3,000,000 for alleged past underpayment of royalties through April 30, 1975, and lease termination on the basis of the alleged underpayment of royalties. In addition, Williams seeks a declaration that future royalties must be based on the prices alleged by Williams to represent market value in the event the lease is not terminated (A. 120).

The parties to the state court litigation have reached an agreement which, if implemented, would resolve that litigation.[5] Implementation of the settlement is dependent upon Commission authorization of one of two alternatives set forth in the agreement, however. Under the first alternative, Pennzoil would increase the basis upon which royalties

[4] *Shell Oil Co. and Pennzoil Producing Co.* v. *Williams, Inc., et al.*, Civil District Court for Orleans Parish, Louisiana, Docket No. 573-591 (A. 4).

[5] As to footnote 4 in the Commission's brief, Pennzoil has seen no evidence to suggest that "market value" royalty clauses are "fairly common," and the Commission cites none. Also, we believe the most that can legitimately be said with respect to the Supreme Court of Louisiana's view on such clauses is that such view, if any, is unknown. *Whitehall Oil Co.* v. *Boagni*, 229 So.2d 702 (La. 1969), cited by the Commission, certainly intimates no such view.

are paid to an amount specified in the agreement contingent upon Commission authorization allowing recovery of the resulting increased royalty costs in the price Pennzoil charges United for the gas. Under the second alternative, the litigation would be settled if the Commission authorized Pennzoil to abandon the sale of the royalty share of the gas so that Williams could take its royalty share in kind.

By its application below, filed under Section 4 of the Gas Act,[6] Pennzoil sought the requisite Commission authorization. Because the price increase is totally based on increased royalty costs and will therefore generate absolutely no profit for Pennzoil, and because this cost is a prudent and necessary expense, Pennzoil believes the price increase to be just and reasonable.

The Commission, however, rejected the price increase request. The Commission first determined the test to be whether "... this *incremental royalty* cost is just and reasonable" (A. 260, emphasis by Comm.).[7] Pennzoil agreed with the Commission that it had properly stated the test, and no party challenged that test on appeal. However, having stated the test to be applied in reviewing Pennzoil's application on the merits, the Commission ignored that test and the record evidence relating to it, and denied relief on the sole ground that, regardless of the facts or consequences, it lacks statutory authority to permit gas producers to collect rates in excess of Commission set ceilings in order to recover incremental royalty costs occasioned either by settlement of market value royalty claims or court order directing payment of such claims. Indeed, the Commission held that it lacked authority to permit collection of any incremental royalty cost "based on other factors than the regulated rate" (A. 260), relying on *FPC* v. *Texaco Inc.*,

[6] 15 U.S.C. § 717c.

[7] The Commission's counsel erroneously implies that it did not thereby implicitly reject the different test on the merits applied by the administrative law judge (Comm. Br. 34).

417 U.S. 380 (1974). On rehearing, the Commission stated that facts showing the proposed rate to be just and reasonable in accordance with Section 4 of the Gas Act "are not controlling. The Commission does not have the power to base a part of the regulated price on the unregulated market value of intrastate gas" (A. 293).

With respect to abandonment, the Commission once again ignored the evidence showing that abandonment of the royalty interest gas would be in accord with the statutory test applicable to abandonment,[8] and denied abandonment on the ground that under its *Southland*[9] decision the gas would remain subject to its jurisdiction even if the lease was terminated and, therefore, the non-existent risk of loss of gas to the interstate market did not justify abandonment (A. 262-63).

The court of appeals reversed on both points (Pet. App. 1a-9a). As to the rate issue, the court held that the Commission has authority to permit a rate increase reflecting incremental royalty costs based on settlement of market value royalty claims and that Pennzoil and Shell Oil are "entitled to a determination of the merits of their requests" (Pet. App. 8a). Noting its reversal of the Commission's *Southland* opinion,[10] the court reversed and remanded the Commission's denial of abandonment authorization (Pet. App. 2a, 8a-9a).

The Commission erroneously represents and implies to the Court that the incremental royalty cost underlying Pennzoil's request for rate relief is "based on the unregu-

[8] *I.e.*, whether "the present or future public convenience or necessity permit such abandonment." 15 U.S.C. § 717f(b).

[9] *El Paso Natural Gas Co.* 54 FPC 145 (1975), subsequently *aff'd sub nom. California* v. *Southland Royalty Co.*, U.S. (1978).

[10] *Southland Royalty Co.* v. *FPC*, 543 F.2d 1134 (5th Cir. 1976), *rev'd sub nom. California* v. *Southland Royalty Co.*, U.S. (1978).

lated price of natural gas in the intrastate market" (Comm. Br. 2, 12, 13, 14, 15, 16, 17, 19, 21, 22, 23, 24, 25, 26, 27, 28, 29, 30, 32). As can be seen from the settlement agreement, the royalty is directly tied to the Commission's own rates (A. 17-18). Basically, the settlement agreement calls for royalty to be based on the higher of 78¢ per Mcf or 150% of the highest Commission set area or national rate. On October 24, 1977, Pennzoil's lessors agreed, effective July 26, 1976, (the date of the Commission's latest national rate opinion[11]) that the royalty would be 100% rather than 150% of the Commission set area or national rate.[12] The 150% figure was agreed upon because it was the figure proposed for small producers by the Commission at the time the settlement agreement was executed.[13] *Small Producer Regulation,* Notice of Proposed Rulemaking, Docket No. R-393 (Sept. 9, 1974), 39 F.R. 33241 (Sept. 16, 1974). The 78¢ figure was exactly 150% of the then-existing national rate of 52¢ per Mcf at the time the settlement was executed. Thus, the incremental royalty is tied directly to Commission set rates[14] and not at all to intrastate rates. While it is true that the claim for royalty based on market value, which in turn may require a consideration of intrastate prices, provided the impetus for settlement (Comm.

[11] Opinion No. 770-A (Nov. 5, 1976), *aff'd, The Second National Natural Gas Rate Cases,* 567 F.2d 1016 (D.C. Cir. 1977), *cert. denied* ___ U.S. ___ (1978).

[12] A copy of such agreement, attached hereto as Appendix A, will be filed with the Commission and Pennzoil's petition for relief will be amended accordingly upon return of this cause to the Commission for disposition on the merits.

[13] Subsequently, the Commission adopted its rule permitting small producers to collect 130% of the national rates. *Small Producer Regulation,* Opinion No. 742, Docket No. R-393 (Aug. 28, 1975).

[14] Thus, the Commission is factually incorrect when it asserts that approval of Pennzoil's proposed rate relief would result in increases in Pennzoil's rates based on "unpredictable market fluctuations" (Comm. Br. 21-22). Pennzoil's rates would change *only* as the Commission changes its jurisdictional rates.

Br. 26), it is factually and logically incorrect for the Commission to assert that the settlement rate is therefore "tied to" or "based on" intrastate rates. The fact is that the settlement royalty increment gives absolutely no consideration to intrastate rates.

SUMMARY OF ARGUMENT

Section 4 of the Gas Act imposes on the Commission the responsibility to insure that the price received for jurisdictional gas sales is just and reasonable. This Court has repeatedly held that by this statutory mandate Congress vested in the Commission the wide discretion required for the Commission to carry out its broad responsibilities under the Gas Act. One of the basic rate making principles inherent in the Commission's authority is that it may take account of prudently incurred costs.

Consistent with that basic principle, this Court has specifically held the Commission has the authority to allow recovery of the specific costs involved in this case — market value royalty costs. *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283 (1974). The Commission believes this Court's decision in *FPC* v. *Texaco Inc.*, 417 U.S. 380 (1974), denied the Commission the very authority upheld in *Mobil*. The Commission also suggests the existence of this authority will somehow undermine its ability to carry out its responsibilities under the Gas Act.

The Commission has reached this erroneous result because it has misapplied *Texaco*. It has also failed to consider its full responsibilities under the Act. A proper reading of *Texaco* and full consideration of all of the Commission's responsibilities allow but one conclusion: as this Court held in *Mobil*, the Commission has the authority to allow recovery of the royalty costs involved in this case.

ARGUMENT

I.

THE COMMISSION SHOULD AND DOES HAVE AUTHORITY TO PERMIT NATURAL GAS COMPANIES TO COLLECT RATES WHICH INCLUDE INCREMENTAL ROYALTY COSTS ARISING FROM MARKET VALUE ROYALTY CLAIMS

The court of appeals held that the Commission has authority to permit a natural gas company to increase its rate to reflect an incremental royalty cost. Of course, Pennzoil agrees that any such proposed rate increase must be found on the merits to be just and reasonable in accordance with the statutory language in Section 4 of the Gas Act.[15] The Commission argues that regardless of the underlying merits of any particular case, it lacks authority to permit such a rate increase. The Commission makes two arguments: (1) possession of such authority would impair the Commission's ability to perform its statutory functions under the Gas Act (Comm. Br. 22-25) and (2) the authorities show the Commission lacks such authority (Comm. Br. 17-21, 26-36).

We will first demonstrate that possession of such authority enhances rather than detracts from the Commission's ability to carry out its responsibilities and then will show that the courts have clearly recognized the existence of such authority and that the Commission's reliance on *FPC* v. *Texaco Inc.*, 417 U.S. 380 (1974), is totally misplaced.

A. Lack of Authority Would Significantly Impair The Commission's Ability to Fulfill Its Responsibilities.

The authority which the Commission denies itself in this case derives from Section 4 of the Gas Act. 15 U.S.C. § 717c. Under Section 4, when a natural gas company (whether a

[15] Only the issue of authority is before the Court, and not whether Pennzoil's proposed rate is just and reasonable on the merits.

producer or a pipeline) proposes a rate increase, the Commission must determine whether the proposed rate is just and reasonable. Inherent in that standard rate-making authority is the requirement that prudently incurred costs be considered. *Smyth* v. *Ames*, 169 U.S. 466, 546-47 (1898).

The Commission argues that it should not have authority to permit prudently incurred incremental royalty costs based on market value claims to be collected if the total rate would exceed area or national levels because:

1. If the Commission has such authority it will be required "to review the circumstances of each case to determine whether particular royalty costs [resulting from market value royalty claims] for natural gas were or were not permissible for individualized reasons" (Comm. Br. 25) "and to determine, for example, the reasonableness of the producer's having incurred particular royalty costs" (Comm. Br. 14); and

2. The Commission could not exclude such costs on the generic ground that they are *per se* improper (Comm. Br. 25).

Pennzoil agrees that those results would follow. Pennzoil believes it to be the Commission's obligation to hear and review individual requests for rate relief and to determine whether, on the merits, they should be granted.[16] The Commission's position could be restated more frankly as: The Commission should not have authority because if it does it will have to perform its duty of reviewing these rate proposals on their merits. We think that an excellent reason to conclude that the Commission has such authority.

[16] The Commission's argument that the court of appeals decision establishes a "presumption that such relief must be granted" (Comm. Br. 13) is absurd. All the decision stands for is the proposition that the Commission has authority to grant relief if a review on the merits demonstrates that such relief would meet the statutory tests.

While it is true that the Commission's responsibilities under the Gas Act are " 'so framed as to afford *consumers* a complete, permanent and effective bond of protection from excessive rates and charges' " (Comm. Br. 18-19, emphasis in orig.), that is only a partial statement of the Commission's responsibilities. Congress' intention was **" 'that natural gas shall be sold in interstate commerce for** resale . . . at the lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest.' " *Atlantic Refining Co.* v. *Public Service Comm. of New York*, 360 U.S. 378, 388 (1959). Thus, the Commission's duty is two-fold, *i.e.,* assure reasonably low prices and assure adequate supply, and one inevitably has an effect on the other. *See, Placid Oil Co.* v. *FPC* 483 F.2d 880, 894-95 (5th Cir. 1973), *aff'd sub nom. Mobil Oil Corp* v. *FPC,* 417 U.S. 283 (1974). The Commission reached its erroneous conclusion because it only considered one-half of the purposes of the Gas Act and gave no thought to the adverse consequences which would flow from its position being sustained.

In order to accomplish these duties, the Commission has been instructed to set "just and reasonable" rates. Consistent with the purposes of the Act, this Court has held that "[a] price is thus just and reasonable within the meaning of §§ 4(a) and 5(a) not merely because it is 'somebody's idea of return on a "rate base,"' but because it results in satisfactory programs of exploration, development and production," *Permian Basin Area Rate Cases,* 390 U.S. 747, 796 (1968) (footnote omitted), and that the Commission is expected to "balanc[e] . . . the investor and the consumer interests." ***FPC* v. *Hope Natural Gas Co.,* 320 U.S. 591, 603 (1944).**

We submit that the Commission cannot hope to achieve those goals unless it has authority to review on the merits rate proposals such as Pennzoil's, for such a review may indeed demonstrate that the proposed rate would be in accord with the purposes of the Act discussed above. If

the Commission lacks authority as it claims it would be unable to act to fulfill its responsibilities. But the Commission's authority has not heretofore been viewed as being so sparse as the Commission now claims. In its first area rate case under Section 4 of the Gas Act, this Court had a broader view of the Commission's authority. "This Court has repeatedly held that the width of administrative authority must be measured in part by the purposes for which it was conferred ... Surely the Commission's broad responsibilities therefore demand a generous construction of its authority," *Permian, supra* at 776 (citations and footnote omitted), and "We cannot, in these circumstances, conclude that Congress has given authority inadequate to achieve with reasonable effectiveness the purposes for which it has acted."[17] *Permian, supra* at 777.

Nor has Section 4 of the Gas Act been given a restricted interpretation. For example, the Commission is permitted to set rates within a "zone of reasonableness" and, within that zone, to "employ price functionally in order to achieve relevant regulatory purposes," and to "require differences in price for simultaneous sales of gas of identical quality, if it has permissibly found that such differences will effectively serve the regulatory purposes contemplated by Congress." *Permian, supra* at 797-98. As the Gas Act provides " 'for regulation along recognized and more or less standarized lines' and that there was 'nothing novel in its provisions,' " *FPC* v. *Hope Natural Gas Co.,* 320 U.S. 591, 616 (1944), costs of providing service are to be reviewed and permitted to be collected if reasonable and prudently incurred. As early as 1898 this Court affirmed that " . . . the sum required to meet operating expenses, are all matters for consideration and are to be given such weight as may be

[17] This Court also noted that the Commission "must be free, within the limitations imposed by pertinent constitutional and statutory commands, to devise methods of regulation capable of equitably reconciling diverse and conflicting interests." *Permian* at 767.

just and right in each case." *Smyth* v. *Ames, supra* at 547.[18]

The only reference to royalty costs in the Gas Act is in Section 14(b), 15 U.S.C. § 717m(b):

> "(b) The Commission ... may also, after hearing, determine the propriety and reasonableness of the inclusion in operating expenses, capital or surplus of all delay rentals or other forms of rental or compensation for unoperated lands and leases."

This Court has stated that Section 14(b):

> "... plainly [was] designed to aid the Commission in its rate-making functions. These provisions all suggest that when Congress designed this Act it was thinking in terms of the ingredients of a rate base, the deductions which might be made, and the additions which were contemplated." *Colorado Interstate Gas Co.* v. *FPC,* 324 U.S. 581, 602 (1945) (footnote omitted).

And referring directly to Section 14(b), this Court also said:

> "[The Commission] allowed, for example, delay rentals and exploration and development costs in operating expenses. . . . Moreover, if in light of experience they turn out to be inadequate for development of new sources of supply, the doors of the Commission are open for increased allowances. This is not an order for all time. The Act contains machinery for obtaining rate adjustments. § 4." *FPC* v. *Hope Natural Gas Co.,* 320 U.S. 591, 615 (1944) (footnote omitted).

These authorities indicate the Commission has authority to review royalty costs and permit their recovery in rates

[18] Royalty, being paid as a charge or fee for producing gas from the lessor's land, is certainly in the nature of an operating expense. Major treatises prior to passage of the Gas Act recognized that all items covering investment, operation and maintenance must be given full consideration in fixing rates. See 2 Pond, *Public Utilities* § 567, p. 1038 (4th ed. 1932).

if found on the merits to be just and reasonable. Congress evinced no intention to treat that cost component differently or to vest authority in the Commission to permit collection of a royalty component equal to but no higher than a fixed percentage of other components, the expenditures for which are not federally-regulated.[19] Had Congress wished to limit the Commission's authority to fulfill its purposes, Congress clearly could have done so.

If the Commission does have the responsibility to assure adequate producer income to assure in turn adequate gas supplies, the Commission's position here would undermine its ability to fulfill its responsibilities and would not, as the Commission argues, be in contravention of the basic scheme of the Act. Pennzoil's reading of the Act and cases is consistent in this regard with language employed by the court of appeals in *Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied* 406 U.S. 976 (1972). In *Mobil* the court, in holding that royalty owners are not natural gas companies, considered the producer's complaint that the Commission order under review, while subjecting royalty owners to Commission jurisdiction, would nevertheless permit royalty owners to sue the producers for royalties in excess of Commission set rates. In that context, the court addressed the issue of authority:

> "More significantly, the FPC's jurisdiction over rates chargeable by a producer includes authority to determine the reasonableness of costs incurred, even though these are not subject to direct FPC control, and that establishes authority to review royalty payments, or

[19] The Court of Appeals for the District of Columbia Circuit stated it slightly differently:

> "Expenses (using that term in its broad sense to include not only operating expenses but depreciation and taxes) are facts. They are to be ascertained, not created, by the regulatory authorities. If properly incurred, they must be allowed as part of the composition of the rates." *Mississippi River Fuel Corp.* v. *FPC*, 163 F.2d 433, 437 (D.C. Cir. 1947).

> drilling rig rentals, or any other element of the producer's cost of service." 463 F.2d at 263 (footnote omitted).[20]

It is frivolous to argue the Commission has the authority to determine the reasonableness of such costs but that if it finds them to be reasonable lacks authority to permit the producer to recoup them; under those circumstances it would be an idle act even to review such costs.

Reasoned analysis of the purposes of the Gas Act, actions necessary to fulfill those purposes and the broad authority accorded the Commission indicates the Commission is incorrect in asserting that possession of the authority it disclaims would undermine its ability to perform its duties.[21] Indeed, the opposite is true.

B. The Commission Possesses Authority To Permit Pennzoil To Collect Its Incremental Royalty Cost.

The Commission's disclaimer of authority in this case is bottomed almost solely on its reading of *FPC* v. *Texaco Inc.*, 417 U.S. 380 (1974), which the Commission reads as prohibiting any portions of a regulated rate from being "based

[20] The Commission's argument (Comm. Br. 18, 30 n. 21) that it would not be *required* to permit flow-through of costs, *e.g.*, for platinum pipe misses the point although it is a correct statement, because it only means that if such costs were not prudently incurred the Commission may reject them. Of course the necessary corollary is that if those costs were prudently incurred the Commission has the *authority* to permit recoupment of those costs.

[21] The Commission's position is inconsistent with its actions on limited term certificates, 18 C.F.R. § 2.70, which were instituted and continued for the express purpose of assuring adequate supplies of gas. See Opinion No. 699-B, Docket No. R-389-B (Sept. 9, 1974) (mimeo at 1-2). The Commission, in order to fulfill its statutory responsibilities, issues limited term certificates at rates measured in substantial part as to justness and reasonableness by intrastate prices. See Opinion No. 699-B, *supra*, mimeo at 3-4; *South Louisiana Production Co.*, Docket No. CI76-208 (Jan. 26, 1976). The Commission's position in this case would seem to affect such actions adversely, so that the adverse effect on the Commission's ability to carry out its duties would extend beyond royalty cases.

on" unregulated gas prices (Comm. Br. 13, 19-21, 27-28) and its reading of *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283 (1974).[22] In addition to being contrary to the purposes of the Gas Act and its responsibilities under the Gas Act, the Commission's position is directly contrary to *Mobil* and is unsupported by *Texaco*.

In fact, the Commission's authority to allow recovery of the specific type of costs involved in this case has already been upheld by this Court. The market value royalty problem in the context of Commission regulated gas sales is not a new problem, nor is it unique to Pennzoil. The potential for the problem has been recognized for years, has been of industry-wide concern, and was first raised for judicial consideration in *Placid Oil Corp.* v. *FPC*, 483 F.2d 880 (5th Cir. 1973), *aff'd sub nom. Mobil Oil Corp.* v. *FPC*, 417 U.S. 283 (1974).

The *Placid* case was a review of the Commission's Opinion No. 598 which established a ceiling area rate for Southern Louisiana based on average costs. The royalty cost component of that rate was attacked on the grounds it failed to take account of the possibility of the precise type of royalty costs involved in this proceeding. The issue was

[22] The Commission's arguments that (1) it may set area or national rates and "is not required" to grant relief when a producer's costs exceed the average (Comm. Br. 18) and (2) it is not required to allow recovery of a cost "if it is excessive or unreasonable" (Comm. Br. 18) are merely statements that the Commission is not *required* to do those acts and have nothing to do with the question of whether it has *authority* to act in this case. The same is true of its argument that it "may" refuse to allow rates resulting from indefinite pricing clauses (Comm. Br. 19).

Further, the Commission's statement that it does not grant relief unless costs exceed revenues (Comm. Br. 15), in addition to not addressing the issue of *authority*, is wrong. *See, e.g.*, *American Petrofina Co. of Texas*, Docket Nos. RI75-17 and RI75-19 (March 3, 1975); *Pioneer Production Corp.*, Docket No. CI73-617 (Nov. 21, 1975) and cases cited therein at footnote 2; *Sohio Petroleum Co.*, Docket No. RI76-47 (Feb. 9, 1976); *Troporo Oil & Gas Co.*, Docket No. RI76-115 (May 10, 1976).

whether the royalty component was inadequate because it was based entirely on the ceiling rate while some producers faced the possibility of having to pay market value royalties based on prices in excess of the ceiling rate. The court of appeals held the royalty component to be adequate. The basis of that holding was not a lack of authority by the Commission to take account of such costs. Instead, the court determined that, because not all producers faced market value royalty costs, it was more appropriate to provide relief from such costs in individualized rather than industry-wide proceedings. Thus, the Court concluded:

> "If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief." 483 F.2d at 911.

This specific holding was reviewed in *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283 (1974). This Court quoted the above-quoted language from *Placid* with approval, affirmed the Court of Appeals determination that individualized relief is an available remedy for royalty costs based on prices in excess of ceiling rates, and held that "... an affected producer is entitled to seek individualized relief." 417 U.S. at 328. This holding is in accord with and is required by the undisputed rate-making principle that account must be taken of prudently incurred costs.

The Commission's suggestion that *Mobil* was merely a recognition of its general authority to grant relief in "some instances where actual costs are higher" but not a recognition that the Commission has the authority to grant relief for incremental royalty costs (Comm. Br. 15, 32) is wrong. *Mobil* was not decided in a vacuum. A reading of both *Placid* and *Mobil* makes it quite clear that this Court was speaking directly to the issue of whether relief may be granted for incremental royalty costs resulting from claims for increased royalty under "market value" leases. Whatever

its current position, the Commission itself in *Mobil* exhibited to this Court full confidence in its ability and authority to grant relief in a case like this. At page 62 of its brief to this Court in *Mobil* the Commission said:

> "Mobil argues . . . that the Commission improperly treated royalty payments as a fixed percentage of total costs, because some producers *may* be required to pay royalties on the basis of higher values. *The court of appeals correctly concluded that* the issue is hypothetical at this stage and that *if it becomes a reality producers may seek special relief from the Commission.*" (First emphasis in original; other emphasis added.)

Pennzoil is not aware of any case, nor has the Commission cited any case, in which a regulatory body either (1) asserted or even suggested it lacked authority to allow recovery of a prudently incurred cost or (2) was held to lack such authority. Yet, although its position flies squarely in the face both of this most basic rate making principle (recovery of prudent costs) and the clear language of *Mobil*, the Commission contends its unique position is compelled by *FPC* v. *Texaco Inc.*, 417 U.S. 380 (1974). The Commission has misapplied *Texaco*.

In *Texaco* this Court reviewed an attempt by the Commission to regulate the price for jurisdictional sales by small producers. The Commission's order attempted to discharge its responsibility indirectly by providing that small producers could receive their contract price (and therefore the small producer price was not directly regulated), but the purchaser would be authorized to recover the purchase cost in its own rates only if the price paid to the small producer did not exceed the unregulated market price. Thus the only standard to which the small producer was to be held, even indirectly, was market price.

This Court held the order invalid. The basis for that holding was the determination that in enacting the Gas Act

Congress necessarily rejected market price as a proper basis upon which sales subject to Commission jurisdiction should be set. In essence, as explained in *FPC* v. *Moss*, 424 U.S. 494, 502 (1976), the order deregulated a transaction (sales by small producers in interstate commerce for resale) Congress had committed to the Commission's jurisdiction.

The Commission's characterization of *Texaco* as being a case where the real issue was whether a component of a large producer's costs, *i.e.*, the cost of gas purchased from a small producer, could be based on intrastate levels (Comm. Br. 27-28) is both incorrect and misleading. In fact, *Texaco* was concerned with whether the *small producer* prices which were required to be regulated could be based solely on intrastate market levels. The essential difference between *Texaco* and this case is that the Commission is required to regulate prices received by small producers but it is not permitted to regulate payments which must be paid to royalty owners.[23]

We are not asking in this case that the Commission act in a manner that will result in deregulation of any transaction subject to its jurisdiction. The Commission does not have jurisdiction over the amount paid by producers to royalty owners. *Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied* 406 U.S. 976 (1972). Therefore, unlike the case in *Texaco* where Congress had determined that small producer prices could not be based solely on market price, there has been no Congressional determination of the basis upon which royalties may be paid. To

[23] The Commission has retreated from its suggestion that the decision rejecting Commission jurisdiction over royalty owners be revisited (Comm. Br. 37, n. 22). In this connection, we dispute the Commission's assertion that the "bind" producers are in is caused by the lack of Commission jurisdiction over royalty owners and claims for royalty based on "market value" (Comm. Br. 32-33). To the contrary, that bind is caused by claims for "market value" royalty payments and the Commission's refusal to provide rate relief to producers.

the contrary, because royalty payments are not subject to Commission jurisdiction, and therefore are not a matter Congress intended that the Commission regulate, the Commission must have authority to allow their recovery as a cost component of the rates the Commission does regulate so long as they are reasonably and prudently incurred.

Furthermore, unlike the procedure the Commission attempted to utilize in the order reviewed in *Texaco*, Pennzoil does not suggest in this case that the Commission allow recovery of the costs involved either (1) solely because the costs are based on market value or (2) without a full inquiry into whether such costs were prudently incurred. First, as noted earlier, the royalty cost is not based on market value at all. Rather, it is tied to Commission ceiling prices and can only change as the Commission revises its prices. Second, Pennzoil does not suggest it should be allowed to recover the royalty cost without full review by the Commission. To the contrary, in accord with the *Texaco* mandate, we have requested the Commission to consider all of the relevant factors and fully expect the Commission to do so should the court of appeals' decision be affirmed. Consequently, unlike the procedure proposed by the Commission in *Texaco*, the Commission here "retains full control over its regulatory jurisdiction." *FPC* v. *Moss*, 424 U.S. 494, 502 n. 9 (1976). Pennzoil is merely seeking to have the Commission exercise its regulatory authority over Pennzoil's rates; Pennzoil is not seeking any deregulation.

Finally, we note that *Mobil* and *Texaco* were decided by this Court on the same day. We have extreme difficulty believing the Court would issue a decision denying the Commission authority to grant relief while at the same time issuing a decision assuring producers they could seek such relief from the Commission.

Two recent Commission orders serve to illustrate the distinctions between this case and *Texaco*. In *Columbia*

Gas Transmission Corp., Docket Nos. RP73-65 (PGA 75-5) (Aug. 1, 1977), the Commission considered, pursuant to the same Section 4 standard applicable to producer rates, the purchased gas cost component of an interstate pipeline's rates. The Commission had previously determined that some of the producer sales pursuant to which the gas in question had been acquired were non-jurisdictional.[24] Consequently, while the price the pipeline was to receive for the resale of the gas was regulated, the price the pipeline had paid for such gas was not regulated, was therefore based on the unregulated market value, and exceeded the ceiling price established by the Commission for producer sales subject to its jurisdiction.[25] Thus, the costs involved in *Columbia* (purchased gas costs) were identical in legal effect to the royalty costs in this case, *i.e.*, the amount paid by the natural gas company whose rates were being reviewed by the Commission was not regulated by the Commission. The Commission had no doubt of its authority to allow recovery of those costs. Rather, the Commission there recognized that because it had no authority to regulate the sales which resulted in the costs involved, the only question was whether the resulting costs were prudently incurred:

> "These purchased gas costs are not inherently different than other expenditures by Columbia which are clearly beyond the jurisdiction of this Commission. . . . The appropriate test to be applied to such expenses is that they be reasonable and prudent."[26]

The Commission reached the same result in *El Paso Natural Gas Co.*, Docket Nos. RP72-150, *et al.* (Feb. 16,

[24] *Columbia Gas Transmission Corp.*, Docket Nos. RP73-65 (PGA 75-5) (April 18, 1977).

[25] *Id.* at 1.

[26] *Columbia Gas Transmission Corp.*, Docket Nos. RP73-65 (PGA 75-5) (Aug. 1, 1977) at 9.

1977), a case involving facts almost identical to those in this case. In *El Paso,* the Commission, acting under Section 4 of the Gas Act, authorized El Paso (an interstate pipeline natural gas company) to recover in its rates increased overriding royalty costs resulting from overriding royalty payments based on prices in excess of the ceiling rate applicable to the vintage of gas involved. The instrument under which the overriding royalty payments are made by El Paso provides for payment based on the market value of the gas, just as the lease royalty provisions in this case do. The claims which resulted in the higher royalty payments were for royalties based on the unregulated intrastate market, just as in this case. The claims were settled, just as in this case. And, just as in this case, the settlement basis was an amount (1) tied to the highest Commission ceiling price and (2) in excess of the ceiling price applicable to the gas involved.

Apparently recognizing the obvious conflict between this case and *El Paso,* the Commission in *El Paso* attempted to distinguish the two. The primary basis set forth by the Commission as justifying the disparate treatment was that the Commission is free to use different methods in setting rates for pipelines (such as El Paso) than it uses in setting rates for independent producers (such as Pennzoil).

The question here is not whether the Commission *must* treat pipelines and producers the same with respect to market value royalty costs, but whether it is *authorized* to do so. And because the Commission's *authority* as to producer rates is conferred by the same statutory language as its authority as to pipeline rates, its *authority* is quite obviously precisely the same as to both. Consequently, while the ultimate treatment *may* be different, the Commission must at least consider on the merits whether the public interest requires that producers be allowed to recover

market value royalty costs just as it requires that pipelines be allowed to recover such costs.[27]

The Commission also states that because Pennzoil is a producer relief is available only if Pennzoil demonstrates that its production costs exceed its revenues from the ceiling rates. Aside from that statement not addressing the question of authority, there is certainly no such requirement in the Gas Act. Consequently, any such requirement would have to result from an exercise of the Commission's authority and a determination that such a requirement is in the public interest under the facts of this case. Again, however, the Commission made no such determination. To the contrary, it determined that overall costs were not in issue, but instead the issue was whether the "*incremental royalty cost* is just and reasonable" (A. 260, emphasis in original). And on that question there can be no dispute. The price increase would generate absolutely no profit because it does nothing more than recover increased costs, and no one has claimed the costs to be recovered were other than prudently incurred. It is therefore not surprising that far from concluding that Pennzoil should not recover the market value royalty costs under the facts presented, the Commission concluded it was "sympathetic to the plight of the producers who face or may face litigation on the value of royalties" (A. 260). It is therefore clear the Commission did not deny relief because it deemed relief to be unjustified, but instead because, as the Commission stated, "we believe that we are not free to allow royalty costs, which are based on market values, to be passed on to pipelines . . . ." (A. 261).

[27] The Commission also asserts that because El Paso is a pipeline, there is no separately established ceiling rate applicable to El Paso's own production. As to new gas, this assertion is wrong. Section 2.66(c) of the Commission's rules and regulations provides that new gas produced by pipelines "shall be" priced at the generally applicable national rate for new gas. 18 C.F.R. § 2.66(c).

Finally, in discussing the prudence of El Paso's market value royalty costs, the Commission made reference to certain purported factual distinctions between this case and *El Paso*. Once again, however, because the Commission viewed its lack of authority as requiring rejection of Pennzoil's request without reference to the facts, it certainly made no finding that Pennzoil's market value royalty costs were imprudently incurred. As stated by the Commission:

> "Pennzoil also notes that no one has contended that the costs involved were improvidently occurred (sic). These considerations are not controlling." (A. 293).

Thus, *El Paso* certainly cannot be distinguished from this case on the grounds the costs in *El Paso* were prudent while those in this case were not.[28] The Commission's effort to distinguish *El Paso* from this case serves only to reveal that there is no distinction. The two cases are the same. The results reached must be the same.

The results in both *Columbia* and *El Paso* are consistent with *Texaco* and are correct. The result reached by the Commission in this case is incorrect because the Commission misapplied *Texaco*. *Texaco* simply holds that the Commission may not deem a price for gas *sold subject to Commission jurisdiction* just and reasonable based solely on the unregulated market price of gas because to do so would be tantamount to deregulating a transaction Congress mandated the Commission regulate. When, as here, the issue is the propriety of recovery of costs resulting from a *non-jurisdictional transaction*, no question of deregulation can possibly arise. Rather, whether the transaction resulting in the costs is non-jurisdictional because it involves a sale of a commodity not subject to the Commission's jurisdiction (such as drill pipe), or because it involves a sale of gas in a market over which the Commission has no authority (as in *Columbia*), or because it involves a royalty payment instead of a gas sale (as in *El Paso* and this case), the result must be the same. The Commission has *authority* to grant relief if justified on the merits.[29] *Texaco* requires nothing different.

[28] Furthermore, the Commission did not even accurately characterize the Pennzoil facts. The Commission noted that El Paso's overriding royalty settlement costs were tied to Commission ceiling rates and were not based solely on intrastate market prices. We have repeatedly informed the Commission that the costs in our case are tied to Commission ceiling rates and are not based on intrastate market prices. The Commission's response has always been (A. 261) and is now (Comm. Br. at 26-27) that the "impetus of the settlement is the market value of the royalties." While that certainly does not transform a cost not based on market value into one based on market value, we simply point out that the "impetus" for the settlement in *El Paso* was precisely the same as that in this case: claims for royalty payments based on market value. The costs in this case are therefore no more based on market value than were those in *El Paso*.

II.

THE ABANDONMENT ISSUE SHOULD BE REMANDED TO THE COMMISSION FOR FULL CONSIDERATION ON THE MERITS

In seeking certiorari, the Commission framed the issue as whether it has authority to grant abandonment of the royalty share of Pennzoil's gas (Pet. 3). Presumably certiorari was granted on that issue. However, in its brief the Commission framed and briefed a wholly different issue, *i.e.*, whether the Commission properly denied abandonment on the merits (Comm. Br. 2, 37-40).

We presume the Commission has dropped any pretense of lack of authority. Section 7(b) of the Act clearly authorized the Commission to grant abandonment if "the present or future public convenience or necessity permit. . . ." 15

[29] As stated by the Commission in *Columbia*, "[t]he appropriate test to be applied to such expenses is that they be reasonable and prudent." *Columbia Gas Transmission Corp.*, Docket Nos. RP73-65, (PGA 75-5) (Aug. 1, 1977) at 9.

U.S.C. § 717f(b). And the Commission did not claim lack of authority in denying abandonment but rested its decision on other grounds (A. 261-63). Whether the Commission lacked authority was never raised before the Commission or before the court of appeals and has not been briefed to this Court by the Commission. To the extent that issue could properly be before this Court, the answer is obvious: The Commission has the authority.

The somewhat confused status of the abandonment issue can be traced to the rather unique treatment the Commission accorded Pennzoil's abandonment request. Pennzoil had suggested to the Commission that if for some reason it did not wish to grant Pennzoil's rate proposal substantially the same beneficial objectives could be achieved by granting abandonment of the royalty share of the gas. One objective which could be achieved by either alternative was to avoid the risk of loss of the entire gas supply if the lessors prevailed in terminating the lease.

Having refused to discuss rate relief on the merits because of its feeling that it lacked authority, the Commission then turned to abandonment. After making the conclusory assertion that "the public convenience and necessity, present or future, is not served by granting an abandonment authorization that would likely result in the subject gas becoming diverted from the interstate market to the intrastate market" (A. 262),[30] the Commission then addressed only one of the several reasons advanced in support of abandonment, *i.e.,* the risk of loss of all the gas if the leases were terminated. Relying on its recently issued *Southland*[31] decision, the Commission found that the interstate market would retain the gas even if the leases were terminated and, with that risk eliminated, abandonment of the royalty gas was unnecessary (A. 262-63).

[30] The statutory test, of course, is not whether the public interest will be *served* by abandonment but whether the present or future public convenience or necessity *permit* abandonment. 15 U.S.C. § 717f(b).

[31] *El Paso Natural Gas Co.,* 54 FPC 145 (1975), *aff'd sub nom. California* v. *Southland Royalty Co.,* U.S. (1978).

The court of appeals reversed and remanded, basing its action on its recent reversal of the Commission's *Southland* decision. *Southland Royalty Co.* v. *FPC,* 543 F.2d 1134 (5th Cir. 1976), *rev'd sub nom. California* v. *Southland Royalty Co.,* U.S. (1978).

The Commission now argues that its abandonment decision should be affirmed on the merits because its *Southland* decision has been upheld. Pennzoil believes the appropriate course of action would be for the matter to be remanded so the Commission can view the matter fully on the merits, including all the arguments and evidence. Pennzoil has not yet had the full consideration of this issue to which it is entitled because of the cursory treatment given it by the Commission. For example, as Pennzoil pointed out to the Commission (A. 221-22; 276), even if the gas remained in the interstate market upon lease termination, the price would increase substantially. If the lease were terminated, Williams would become the seller. Williams qualifies as a "small producer" and would be entitled to receive "small producer" prices. *See Jicarella Apache Tribe* v. *FERC,* 578 F.2d 289 (9th Cir. 1978). The small producer prices which Williams would receive are about thirty percent higher than the prices Pennzoil, as a large producer, may collect.[32] Consequently, the possibility of lease termination presents a very serious risk (higher prices for *all* of the gas) the avoidance of which may justify abandonment of a fraction of the gas. Yet the Commission has given no attention at all to this consideration.

[32] *Small Producer Regulation,* Opinion No. 742, Docket No. R-393 (Aug. 28, 1975). The price small producers may collect for "new" gas is the same as large producers may collect, but there is no new gas involved in this case.

Furthermore, when the Commission rejected the abandonment request, it believed it had no authority to grant price relief. Should Pennzoil prevail on the rate issue, the Commission may on remand determine that the abandonment alternative is preferable to the price increase alternative. The Commission should not be denied the latitude to resolve the problem with either alternative.

As for the Commission's argument, we do not believe the fact that without abandonment authorization the gas will remain in interstate commerce (a truism in all abandonment cases) is adequate reason for the Commission to avoid its responsibility of determining whether the full evidence shows that "the present or future public convenience or necessity permit abandonment." 15 U.S.C. § 717f(b). For these reasons, this issue should be remanded.

CONCLUSION

The judgment of the court of appeals should be affirmed.

JOHN M. YOUNG
General Attorney
Pennzoil Producing Company
3100 Pennzoil Place
Houston, Texas 77001

JERON STEVENS
STEPHEN M. HACKERMAN
Baker & Botts
3000 One Shell Plaza
(713) 229-1234

Counsel For
Pennzoil Producing Company

CERTIFICATE OF SERVICE

I hereby certify that I have served this brief on all parties on October 5, 1978, in accordance with the rules.

....
JERON STEVENS

APPENDIX A

October 24, 1977

Pennzoil Producing Company
Pennzoil Place
P. O. Box 2967
Houston, Texas 77001

Attention: Mr. A. Duncan Gray, Jr.

Shell Oil Company
P. O. Box 60193
New Orleans, Louisiana 70160

Attention: Mr. Alvin G. Gibson

Gentlemen:

Section I of the settlement agreement between Pennzoil and Shell ("lessees") and Williams, Inc., *et al.*, ("lessors") dated June 18, 1975, sets forth two procedures, namely the so-called "royalty tracker" procedure and the so-called "abandonment" procedure. The royalty tracker generally provides, under current circumstances, for a royalty to be paid on an amount equal to 150% of the "base alternative rate" plus certain adjustments, as the term "base alternative rate" is defined and used in Section I.A. of the agreement.

Section II.A. of the agreement provides that the settlement agreement will be implemented if the FPC authorizes either of the procedures described in Section I. and if the FPC authorizes any other procedure acceptable to all parties to the agreement.

Considering all current circumstances, and in an effort to achieve prompt and final resolution of the matter, lessors have determined that the following is an acceptable alternative procedure under Section II:

1. For the period from the effective date of an FPC order authorizing a royalty tracker in an amount equal to the royalties which would be paid under this alternative procedure through July 26, 1976, the amount of royalty payments shall be determined in the manner set forth in the Settlement Agreement, and

2. Commencing July 27, 1976, the amount of royalty payments shall be determined in the manner set forth in the Settlement Agreement except that "100%" shall be substituted for "150%" in Section I.A. of the Settlement Agreement.

In the event the FPC authorizes a royalty tracker in an amount equal to the royalty payments that would be made under the alternative procedure described above, lessors will amend the Settlement Agreement as necessary to incorporate such alternative procedure therein.

In view of all of the circumstances, lessors believe the alternative procedure set forth above is a reasonable settlement basis and authorize Pennzoil and Shell to propose such alternative procedure to the FPC.

Yours very truly,
WILLIAMS, INC.

FRANK B. WILLIAMS
President

FBW: fw

IN THE
Supreme Court of the United States
OCTOBER TERM, 1978

NO. 77-648

FEDERAL ENERGY REGULATORY COMMISSION,
Petitioner

v.

PENNZOIL PRODUCING COMPANY, *ET AL.*,
Respondents

On Writ of Certiorari to the United States Court of Appeals For the Fifth Circuit

BRIEF OF RESPONDENT UNITED GAS PIPE LINE COMPANY

LEE M. HUBER
700 Milam
P. O. Box 1478
Houston, Texas 77001

DONALD R. ARNETT
AUSTIN & ARNETT
1938 Bank of the Southwest Bldg.
Houston, Texas 77002

Attorneys for Respondent
United Gas Pipe Line Company

Alpha Law Brief Co., One Main Plaza, No. 1 Main St., Houston, Texas 77002

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IN THE

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OCTOBER TERM, 1978

NO. 77-648

FEDERAL ENERGY REGULATORY COMMISSION,
Petitioner

v.

PENNZOIL PRODUCING COMPANY, *ET AL.*,
Respondents

On Writ of Certiorari to the United States Court of Appeals For the Fifth Circuit

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BRIEF OF RESPONDENT UNITED GAS PIPE LINE COMPANY

QUESTIONS PRESENTED

1. Whether the Federal Energy Regulatory Commission has the authority to grant individual relief by permitting natural gas producers to reflect in their rates for sales of gas to pipelines incremental costs reflecting royalties actually incurred.

2. Whether, having refused to grant the individual rate relief requested, the Federal Energy Regulatory Commission erred in holding that the present or future public convenience or necessity did not permit abandonment of the royalty portion of the gas sold in interstate commerce.

STATEMENT OF THE CASE

Pennzoil Producing Company (Pennzoil) and Shell Oil Company (Shell) sell natural gas produced from the Gibson Field, Terrebonne Parish, Louisiana, to United Gas Pipe Line Company (United). A portion of the gas sold to United is produced from acreage covered by leases from Williams, Inc. *et al.* (Williams). The prices Pennzoil and Shell are permitted to collect from United for the sale of the gas are subject to the jurisdiction of the Federal Energy Regulatory Commission (Commission) under the Natural Gas Act, 15 U.S.C. § 717 *et seq.*, and to the applicable just and reasonable rates established by the Commission. Williams, however, has claimed that under its leases it is entitled to the payment of royalties on the basis of the market value of the gas rather than on the basis of the regulated price.[1] As a result of this claim, Pennzoil and Shell asked a Louisiana state court to declare that Pennzoil and Shell were paying correct royalties (A. 75-99).[2] By reconventional demand Williams asked the state court to declare the leases terminated, to assess damages for the alleged underpayment of royalties, and, in the event the leases were not terminated, to declare that future royalties must be based on prices alleged by Williams to be the market value (A. 116-117).

Subsequently, Pennzoil, Shell and Williams entered into a settlement agreement (A. 15-25). Among other provisions of this agreement, which if implemented would resolve the pending market value royalty litigation, Pennzoil and Shell agreed to seek Commission authorization to collect increased rates from United or, in the alternative, in the event that Commission authorization for the increased rates is denied, to seek authorization to abandon the sale of the royalty portion of the gas to United. The increased rates requested would reflect increased royalty costs, based upon the agreed upon rates set forth in the settlement agreement (A. 17-20), which are substantially less than those demanded by Williams as market value (A. 43, 66-67). The entire amount of the increase received from United would pass directly to Williams, and neither Pennzoil nor Shell would keep any amount of the incremental royalty increase.

Pursuant to the terms of the settlement agreement, Pennzoil and Shell sought Commission authorization to collect increased rates from United which would reflect the increase in royalty costs as provided for in the settlement agreement, or, alternatively, in the event the Commission denied the requested increases, Pennzoil and Shell sought Commission authorization to abandon the sale of the royalty portion of the gas to United (A. 2-6, 7-31). United sought leave to intervene in these proceedings, which was granted by Order of the Commission issued on September 22, 1975 (A. 39).

United intervened in the Commission proceedings on the basis of letter agreements it had executed with Pennzoil and Shell in which United agreed, subject to Commission approval, to pay the increased rates, or, alternatively, to release the royalty portion of the gas from its gas purchase contracts (A. 122-125, 126-129). United executed these agreements after being advised

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1. *Texas Oil and Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968); *Lightcap v. Mobil Oil Corp.*, 562 P.2d 1, *cert. denied*, 434 U.S. 876, petition for rehearing pending.

2. *Shell Oil Co. and Pennzoil Producing Co. v. Williams Inc., et al.*, Civil District Court for Orleans Parish, Louisiana, Docket No. 573-591 (filed May 24, 1974).

of the pending market value royalty litigation, its possible adverse results, and that in an effort to settle the litigation, Pennzoil and Shell had entered into the settlement agreement with Williams. United took the position that it preferred Commission approval of the increased rate alternative, it being understood that the increases would be reflected in United's jurisdictional rates (A. 197). Commission approval of this alternative would ensure that all of the gas attributable to the Williams' acreage would remain available to United and its customers. However, if the rate alternative were denied, United then supported Commission approval of the abandonment alternative. Commission approval of the abandonment of the royalty portion of the gas would be preferable to the risk of lease cancellation and possible loss of all the gas to the interstate market and would at least keep the working interest portion available to United.

The Commission denied Pennzoil's and Shell's requests for increased rates by holding that it did not have the authority to allow producers increased rates based upon increased royalty costs calculated on a rate in excess of the Commission's just and reasonable rates. Citing this Court's decision in *Federal Power Commission v. Texaco,* 417 U.S. 380 (1974), the Commission stated (A. 261):

> Accordingly, we believe that we are not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates.

In denying the requests for abandonment authorization, the Commission held that neither of the two conditions for abandonment under Section 7(b) of the Natural Gas Act, 15 U.S.C. § 717f(b), had been met. The Commission

found first, that the supply of gas had not been depleted and second, that the present or future public convenience or necessity did not require that abandonment be authorized. The Commission relied upon its Opinion No. 737,[3] for its determination that even if the litigation with Williams were lost and Pennzoil's and Shell's leases were terminated, the gas would remain committed to the interstate market.

On appeal, the United States Court of Appeals for the Fifth Circuit reversed the Commission. The Fifth Circuit held that the Commission erred in failing to realize it had the authority to permit rate relief, as this Court previously had held in *Mobil Oil Corp. v. Federal Power Commission,* 417 U.S. 283 (1974), and remanded the rate relief issue for a determination as to whether the relief requested should be granted. The Fifth Circuit stated:

> Petitioners followed the proper procedures in petitioning the Commission for special relief and were entitled to a determination of the merits of their requests. In *Mobil Oil Corp. v. FPC,* 417 U.S. 283, 94 S.Ct. 2328, 41 L.Ed.2d 72 (1974), *aff'g Placid Oil Co. v. FPC,* 483 F.2d 880 (5th Cir. 1973), decided the same day as *Texaco,* the Supreme Court, in response to Mobil's complaint that the FPC failed to provide automatic adjustments in area rates to compensate for anticipated higher royalty costs, reiterated the Court of Appeals' finding that "'(i)f, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individual relief.'" 417 U.S. at 328, 94 S.Ct. at 2355. Pennzoil and Shell

3. *El Paso Natural Gas Co.,* Opinion No. 737, Docket No. CP75-209 (July 11, 1975), *reh'g denied,* Opinion No. 737-A (September 3, 1975).

> have been put in such a bind. If they lose the state court litigation, they are faced either with termination of their leases, which could divert the entire amount of gas from interstate commerce, or with increased royalty payments, which would absorb funds otherwise available for exploration and development. 553 F.2d at 488-9.

Further, the Fifth Circuit reversed and remanded for further consideration the Commission's rejection of the abandonment alternative. Relying on its decision in *Southland Royalty Co. v. Federal Power Commission*, 543 F.2d 1134 (5th Cir. 1976),[4] the Fifth Circuit held that in denying the abandonment requests, the Commission had acted under the wrong legal premise in assuming that the gas would remain committed to the interstate market if the leases were cancelled as a result of the state court litigation.

A petition for a writ of certiorari to the Unted States Court of Appeals for the Fifth Circuit was filed by the Commission and an order granting certiorari was entered by this Court on June 12, 1978 (A. 303).

SUMMARY OF ARGUMENT

A. The royalty owner under the Pennzoil and Shell leases filed suit to cancel the leases for the failure to pay royalties on the basis of the market value of the gas produced, and the parties entered into a settlement agreement providing for the payment of royalties based upon an agreed rate which is more than the Commission regulated rate and less than the market value. Pennzoil and Shell have been placed in the "bind" foreseen in *Placid Oil Co. v. Federal Power Commission*, 483 F.2d 880 (5th Cir. 1973) and have sought individualized relief as authorized by the Fifth Circuit in *Placid* and this Court in *Mobil*. However, the Commission has ruled that it does not have the authority to grant individualized relief for excess royalties, regardless of what showing a producer may make, and, therefore, that this Court did a useless thing in *Mobil* by holding that a producer may seek individualized relief for royalty costs actually incurred.

4. Subsequently reversed by this Court in *California v. Southland Royalty Co.*, 98 S.Ct. 1955 (1978).

Placid and *Mobil* specifically authorize gas producers to seek individualized relief for royalty costs actually incurred and authorize the Commission to grant the relief upon a proper showing. This holding is fundamental to cost-based regulation. The regulated entity is entitled to have the opportunity to recover its actual costs, plus a fair rate of return. When the regulation is based upon industrywide average costs, as Commission regulation is based, there must be an opportunity to seek individualized relief. The Commission recognizes this principle, and its Regulations and Statement of General Policy specifically authorize a producer to seek individualized relief for costs actually incurred. However, the Commission argues that this Court's opinion in *Texaco* holds that royalty costs are the sole exception to this fundamental principle and that the Commission has no authority to grant special relief for royalty costs actually incurred, regardless of the showing made by the producers. The Commission argues that the estimate of industrywide average royalty costs must be included in the producer rate, just as the estimate of industrywide average successful well costs must be included in the producer rate. However, the

Commission argues that it may grant individualized relief for successful well costs actually incurred but that *Texaco* holds that it may not grant individualized relief for royalty costs actually incurred.

The Commission misreads *Texaco.* In *Texaco,* this Court held that the Commission may not equate the market value of gas and the just and reasonable rate for gas. This Court held that the market value is not *ipso facto* the just and reasonable rate. However, *Texaco* specifically holds that the market value may be considered in determining the just and reasonable rate. If market value may be considered in determining the overall just and reasonable rate, *a fortiorari* market value may be considered in granting relief for costs actually incurred.

The authority to grant individualized relief will not result in loss of Commission control of rates nor cause an administrative burden. The Commission presently considers requests for individualized relief for costs incurred, other than royalty costs, and grants some requests and denies some requests. Requests for individualized rate relief for royalty costs incurred are no different in principle.

B. The Commission held that the present or future public convenience and necessity does not authorize the granting of abandonment of the royalty share of the gas for the sole reason that the gas would remain dedicated to interstate commerce under the holding of *California v. Southland Royalty Company* even if the leases are cancelled for failure to pay proper royalties. *Southland Royalty* is still before this Court. Moreover, whether the gas would remain dedicated to interstate commerce is not the sole consideration. For example, the Commission must consider if it is in the public convenience and necessity for the leases to remain under the management of experienced operators who have the capital resources to maintain the leases, or whether the public convenience and necessity permits the leases to revert to the mineral owner when it has not been shown whether the mineral owner could operate the leases efficiently and whether the mineral owner has sufficient capital to maintain the leases.

ARGUMENT

I.

THE COMMISSION HAS AUTHORITY TO GRANT INDIVIDUALIZED RELIEF TO NATURAL GAS PRODUCERS FOR ROYALTIES ACTUALLY INCURRED.

1. This Court's opinion in *Mobil Oil Corporation v. Federal Power Commission* expressly authorized the granting of relief from royalty obligations based upon a price higher than the regulated rate.

The Commission has posed the question whether the Commission has authority to grant to natural gas producers individualized rate relief for royalty costs actually incurred when those costs are based on the unregulated market price of natural gas.[5] The question was answered

5. The question presented in this proceeding is not whether the producers have made a proper showing for entitlement to individualized relief; the question presented is whether the Commission has the authority to grant individualized relief to natural gas producers for royalties actually incurred when a proper showing has been made. The Fifth Circuit Court of Appeals correctly held that the Commission does have this authority and remanded the cause for determination by the Commission on the merits.

in the negative by the Commission in its opinion in this proceeding, but this question has been answered in the affirmative by the Court of Appeals for the Fifth Circuit in this proceeding and in *Placid Oil Co. v. Federal Power Commission, supra,* and by this Court in *Mobil Oil Corp. v. Federal Power Commission, supra,* affirming *Placid.*

In the Southern Louisiana Area Rate Proceeding, Mobil Oil Corporation foresaw that producers would incur royalty costs based on the unregulated price of natural gas and asked the Commission to provide an adjustment in its Opinion No. 598, which established area rates for Southern Louisiana.

In *Placid,* the Fifth Circuit reviewed and upheld the Commission's Opinion No. 598, and, in response to Mobil Oils complaint that the Commission failed to provide for an adjustment in area rates to compensate for anticipated higher market value royalty costs, the Fifth Circuit stated:

> If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition the FPC for individualized relief. *Permian* contemplated it. 483 F.2d at 911.

Placid was affirmed by this Court *sub nom. Mobil Oil Corp. v. Federal Power Commission, supra,* in which this Court expressed complete agreement with the Fifth Circuit:

> Mobil argues that . . . the 1971 rate schedules must take into account the possibility of higher royalty obligations. We agree with the Court of Appeals that Mobil's argument is hypothetical at this stage and that in any event an affected producer is entitled to seek individualized relief. 417 U.S. at 328.

Mobil Oil's argument was "hypothetical" as to royalties paid on rates in excess of the ceiling rate only because Mobil Oil was not then faced with the payment of such a royalty. As Mobil Oil stated to the Fifth Circuit:

> * * * Royalty payments will exceed the levels used in arriving at costs to fix rates, and realization to producers will be reduced to the extent that royalty payments exceed those assumed by the Commission and are based on "current market value" in Southern Louisiana as determined from time to time for the periods covered by the Commission's area rate orders.[6]

Since the royalty payments "will exceed", rather than "had exceeded", the Fifth Circuit and this Court stated that the argument is hypothetical but that when the hypothetical problem becomes a reality, "an affected producer is entitled to seek individualized relief". The very question raised by Mobil Oil is no longer hypothetical. It is a reality, and the affected producers have sought individualized relief.

However, the Commission ignores that this is the very problem foreseen by Mobil Oil and argues that, while an affected producer may seek relief, the Commission may not grant relief. This emasculates this Court's *Mobil* opinion. It is idle to seek individualized relief when the Commission has no authority to grant the relief. The Commission seeks to avoid the appearance of robbing

6. Brief for Petitioner at 69, *Placid Oil Company v. Federal Power Commission,* 483 F.2d 810 (5th Cir. 1973).

Mobil of its clear meaning by arguing that this Court did not say in what circumstances the Commission may grant relief. The brief filed by Mobil Oil in that proceeding makes clear that Mobil Oil was talking about the precise "hypothetical" problem that is now a reality and that this Court was addressing that precise "hypothetical" problem when it stated that "an affected producer is entitled to seek individualized relief". In its brief to this Court, Mobil Oil stated:

> * * * The Commission . . . refused to include in its rate structure a clause providing for adjustment of the base area rates where producers . . . are required to pay royalties on the basis of "market value" or other bases higher than producer rates prescribed by the Commission.
>
> * * *
>
> In the more recent Commission Docket No. AR-70-1, Mobil demonstrated that far more than a "hypothetical" problem now exists. There, Mobil advised that the State of Texas has filed an Original Petition in the District Court of Travis County, Texas, 53rd Judicial District against Mobil, claiming that the State of Texas,
>
> ". . . is entitled to receive the 'Market Price' for its royalty at the time of the sale."
>
> and
>
> ". . . that the State of Texas, as a royalty owner is not limited to any regulated ceiling prices as promulgated by the Federal Power Commission. . . ."
>
> The Commission has been advised that other efforts to obtain such royalty payments are being made, and that producers' revenues in all areas are similarly threatened. However, the Commission errs in ignoring that producers are now facing such claims for payment of royalty on "market values" which are substantially above the Commission-prescribed producer area rate ceilings.[7]

The Fifth Circuit correctly noted in its opinion below that the claim for higher royalties and the state court litigation have put Pennzoil and Shell in the bind mentioned in *Placid,* 553 F.2d at 488, that the Commission erred when it "failed to realize it had the authority to grant relief", 553 F.2d at 486, and correctly held that "Petitioners followed the proper procedures in petitioning the Commission for special relief and were entitled to a determination of the merits of their requests." 553 F.2d at 488.

2. This Court's opinion in *Federal Power Commission v. Texaco, Inc.* is consistent with *Mobil.*

The Commission recognizes that *Mobil* specifically authorizes an affected producer to seek individualized relief for royalty obligations based upon the unregulated market value, but argues that *Federal Power Commission v. Texaco Inc.,* 417 U.S. 380 (1974), denies it authority to grant individualized relief for royalty costs higher than those provided for in the regulated rate.[8] In effect, the Commission finds *Mobil* and *Texaco* to be inconsistent and gives controlling weight to *Texaco.*

---

7. Brief for Petitioner at 81-83, *Mobil Oil Corporation v. Federal Power Commission,* 417 U.S. 283 (1974).

8. The settlement rate in this proceeding is less than the market value, but the Commission equated the two by stating that it may not grant individualized relief "for additional royalty payments which are based on other factors than the regulated rate" (A. 260).

Texaco was handed down by this Court on the same day that this Court affirmed *Placid* in *Mobil*. This Court obviously saw no conflict between *Texaco* and *Mobil*, and no conflict exists.

In *Texaco*, this Court reviewed the Commission's Order No. 428 dealing with the regulation of "small producer" sales. This Court held Order No. 428 to be invalid because of its use of the market price as the *sole* determinant of the just and reasonable small producer rate, thereby equating the market price and the just and reasonable rate, or, as this Court stated, ". . . the prevailing price in the marketplace cannot be the final measure of 'just and reasonable' rates mandated by the Act." 417 U.S. at 397. The Court found Order No. 428 to exempt small producer rates from regulation.

> Sections 4 and 5 of the Act require that all gas rates be just and reasonable; and the Court held in *Phillips* that this very prescription applies to the rates of all gas producers. The Commission may have great discretion as to how to insure just and reasonable rates, but it is plain enough to us that the Act does not empower it to exempt small-producer rates from compliance with that standard. 417 U.S. at 394.

Texaco proscribes the use of the unregulated market price as the *sole* standard for determining the just and reasonable rate, but it does not proscribe the use of the unregulated market price as one element to be considered in determining the just and reasonable rate. On the contrary, this Court expressly stated in *Texaco* that it did not "mean that the market price of gas would never, in an individual case, coincide with just and reasonable rates or not be a relevant consideration in the setting of area rates . . . ; it may certainly be taken into account . . ."

417 U.S. at 399. If the unregulated market price may be taken into account in setting the area rate itself, *a fortiorari* it may be taken into account in granting individualized relief from the area rate. If the unregulated market price may be taken into account in setting the area rate itself, *a fortiorari* it may be taken into account in granting individualized relief for a single component of the area rate.

3. The higher royalty obligation is an actual cost, and individualized relief may be granted for higher costs.

The Commission has adopted a cost-based regulation and bases its just and reasonable rates upon estimated industrywide average costs. This methodology was applied to a geographical area of the nation and approved by this Court in *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968). The establishment of a national rate by this methodology was approved in *Shell Oil Company v. Federal Power Commission*, 520 F.2d 1061 (5th Cir. 1975), cert. denied, 426 U.S. 941 (1976). In *Shell*, the Fifth Circuit noted that the overall cost determination was based upon an evaluation of thirteen individual cost components, including such components as Successful Well Cost, Lease Acquisition Cost, Cost of Other Production Facilities, and Royalty Expense. Each component is intended to be the estimated actual cost of that component. For example, the estimated Successful Well Cost is determined by reference to the actual market cost of drilling and equipping a successful well, and Lease Acquisition Cost is determined by reference to the actual market cost of leases bought from private landowners and governmental entities, including the Department of

the Interior. The determination is intended to take into account actual costs.

As noted in *Shell*, Royalty Expense is one of the cost components of an area rate or nationwide rate. In the overall cost determination:

> *Royalty Expense* represents the percentage of the gross receipts which a producer must pay to the landowner for the privilege of extracting from the reserves underlying his land. It was computed by applying a percentage to the gross receipts. 520 F.2d at 1068.

In "applying a percentage to the gross receipts", the Commission treated the regulated rate itself as being the gross receipts and applied a percentage to the regulated rate to determine the actual cost of Royalty Expense.

Some leases do provide for a landowner's royalty of a "percentage of the gross receipts", and the actual cost of the Royalty Expense of these leases is considered in the area rate or nationwide rate. However, some leases provide for a percentage of the market value of the gas, even though the market value exceeds the gross receipts from the sale of the gas, and for those leases the royalty paid is a percentage of the market value, not a percentage of the gross receipts. Since the Royalty Expense in an area or national rate determination is computed "by applying a percentage to the gross receipts" instead of by applying a percentage to the market value, the actual royalty cost in market value leases exceeds the Royalty Expense allowed in the area or national rate. This is the exact fact situation foreseen by Mobil Oil in *Placid* and *Mobil*.

It is fundamental to cost-based regulation that the regulated entity must be permitted the opportunity to recover its costs incurred, plus a fair rate of return. Where the regulation is based upon industrywide average costs, there must be an opportunity for individualized relief for actual costs incurred.

The Commission has provided for individualized relief in Section 154.105(j) of its Regulations and Sections 2.56a and 2.56b of its Statement of General Policy and Interpretations Under the Natural Gas Act (18 C.F.R. § 154.105(j) and 18 C.F.R. § 2.56a and 2.56b). The Commission has granted relief for such costs as compression and remedial well work, even though these costs are determined by an uncontrolled market, and the Fifth Circuit correctly noted that "the Commission has failed to suggest why royalty costs in an uncontrolled market are any different from any other cost." 553 F.2d at 488.

4. The authority to grant individualized relief is consistent with Commission regulation.

The Commisison argues that the authority to grant individualized relief to Pennzoil and Shell is contrary to basic principles of regulation. The Commission is in error. The authority to grant individualized relief is consistent with the principles of regulation and is consistent with Commission precedent. The Commission does grant individualized relief based upon costs actually incurred and has done so for years.

The Commission argues that:

a. While the Commission may grant individualized relief, ". . . it is not required to do so merely

because the producer's own costs exceed the area or national average." Brief, p. 18.

No one here argues that the Commission is required to grant the relief requested. That question is not presented. The sole issue in this proceeding is whether the Commission has the authority to grant the relief requested.

b. ". . . The fact that one or even all producers incur a particular cost does not require the Commission to include all of that cost in the rate base if it is excessive or unreasonable." Brief, p. 18.

No one here argues that the Commission is required to grant the relief requested. The Commission has not made a finding that the cost to be incurred is excessive or unreasonable. The only determination that the Commission has made is that it has no authority to grant the relief requested, and the question of authority is the sole question before the Court.

c. The Commission may refuse to establish rates that reflect contract clauses providing for indefinite price escalations. Brief, p. 19.

No one here questions this statement. No contract clauses providing for indefinite price escalations are involved in this proceeding.

d. The Commission may not establish rates on the basis of the unregulated market price of natural gas. Brief, p. 19.

The Commission's statement is a correct reading of *Texaco*. The Commission may not equate the

unregulated market price per Mcf of gas for the per Mcf regulated rate, and that is not what the Commission is being asked to do. The Commission is being asked to grant relief for a *cost* actually incurred. The Commission has granted special relief for such costs as drilling costs and workover costs. The cost of royalty is no less a component of the producer's cost than is the cost of drilling.

e. If the Commission permitted a rate increase for the increased royalty, jurisdictional rates would be subject to unpredictable fluctuations and escalations beyond the control of the Commission. Brief, p. 21.

This is a phantom that experience has shown does not exist. No one here argues that relief is automatic. If it were, there would be no necessity to request the relief. The Commission has granted individual relief for years, and there have not been unpredictable fluctuations and escalations beyond the Commission's control. The Commission has considered each request on an individual basis—it has exercised control on an individual basis—and that is all the Commission is asked to do in this proceeding. Nothing is automatic. Nothing is uncontrolled.

f. The Court of Appeals decision would compel the Commission to permit royalty cost pass-throughs in many, if not in most, cases. Brief, p. 23.

The Court of Appeals decision would not compel the Commisison to do anything except to decide

the merits of the request for relief by Pennzoil and Shell. The Commisison has the authority to grant individualized relief for costs incurred by producers and over the years has granted some requests and denied some requests, but the Commission has never before argued the *non sequitur* that the authority to consider the requests compels the granting of the requests. No one makes that argument here.

II.

THE ISSUE OF ABANDONMENT OF THE ROYALTY PORTION OF THE GAS SHOULD BE REMANDED TO THE COMMISSION FOR FULL CONSIDERATION ON THE MERITS.

As an alternative to their request for rate relief, Pennzoil and Shell sought abandonment of the royalty portion of the gas. As the rate alternative was denied, abandonment of the royalty portion of the gas became preferable in light of the consequences if the state court litigation were lost. Commission approval of the abandonment alternative would ensure that the working interest portion of the gas remain available to United.

Under Section 7(b) of the Natural Gas Act, 15 U.S.C. § 717f(b), abandonment can be granted on a showing that the available supply of gas is depleted to the extent that the continuation of service is unwarranted or that the present or future public convenience or necessity permit such abandonment. There was no evidence here of depletion of supply, therefore the question was whether

the present or future public convenience or necessity permits such abandonment.

United argued that in this time of a severe gas supply shortage in the interstate market, the Commission must find that it is in the public interest to retain as much gas as is available to the interstate market; that approval of the abandonment alternative would eliminate the risks of the litigation and possible lease cancellation and would at least insure the retention of the working interest portion to the interstate market; and that abondonment is permitted by the statutory test of the present or future public convenience or necessity.

The Commission held that the present or future public convenience or necessity does not permit approval of the abandonment alternative. In responding to United's argument the Commission stated:

> . . . once the gas is dedicated, we do not share the concern of Pennzoil and United that Williams could terminate deliveries to United even if the leases were cancelled as a result of state court litigation. If the lease were cancelled and Williams were to undertake to sell the subject gas, Williams would simply assume the obligations of Pennzoil and Shell to continue service to United. (A. 262).

The Commission was relying on its Opinion No. 737.

The Fifth Circuit, subsequently reversed Opinion No. 737 in *Southland Royalty Co. v. Federal Power Commission, supra,* and in light of its decision, remanded the abandonment issue to the Commission for reconsideration. The Fifth Circuit held that the Commission was acting under the wrong legal premise in that "the Com-

mission was under the impression that Williams' gas was trapped in the interstate market, whether or not the leases were terminated" (Pet. App. 9a).

This Court has recently reversed the Fifth Circuit's decision in *California v. Southland Royalty Co.*, 98 S.Ct. 1955 (1978), and upheld the Commission's Opinion No. 737. In its Brief, the Commission states that by the principles enunciated in *Southland Royalty* Williams would be obligated to continue the interstate service initiated by Pennzoil and Shell to United, even if the leases were cancelled by the state court litigation. The Commission concludes that the Fifth Circuit's holding on the abandonment issue should be reversed and the Commission's determination affirmed.

It is United's contention that the abandonment issue should be remanded to the Commission for reconsideration to determine whether the public convenience or necessity would permit abandonment of the royalty portion, if the rate relief alternative is denied. First, *California v. Southland Royalty Co.*, is currently pending on rehearing before this Court. Secondly, if the state court litigation were lost and the leases cancelled but under the principles enunciated in *Southland Royalty* Williams was compelled to continue interstate service to United, United would still have concerns. The continuation of deliveries in interstate commerce is not the sole consideration. For example, it is not shown that Williams has experience as a producer of natural gas or the capital necessary for additional work on the leases as was projected by Pennzoil and Shell to bring forth additional supply, if the settlement agreement was approved (A. 47-48, 67).

CONCLUSION

For the reasons stated in this brief, United requests this Court to affirm the judgment of the Fifth Circuit and to remand to the Commission for further proceedings to consider the merits of Pennzoil's and Shell's application.

Respectfully submitted,

LEE M. HUBER
700 Milam
P. O. Box 1478
Houston, Texas 77001

DONALD R. ARNETT
AUSTIN & ARNETT
1938 Bank of the Southwest Bldg.
Houston, Texas 77002

Attorneys for Respondent
United Gas Pipe Line Company

CERTIFICATE OF SERVICE

I hereby certify that I have served three copies of Brief of Respondent United Gas Pipe Line Company on counsel of record for the other parties by depositing copies of it in the United States Mail, postage prepaid on October 4, 1978.

DONALD R. ARNETT

IN THE
Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION,
Petitioner,

v.

PENNZOIL PRODUCING COMPANY, ET AL.,
Respondents.

BRIEF OF RESPONDENT SHELL OIL COMPANY

THOMAS G. JOHNSON
Attorney for
SHELL OIL COMPANY
One Shell Plaza
P. O. Box 2463
Houston, Texas 77001

October 5, 1978

Alpha Law Brief Co., One Main Plaza, No. 1 Main St., Houston, Texas 77002

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BRIEF OF RESPONDENT SHELL OIL COMPANY

COUNTERSTATEMENT OF THE CASE

For over ten years the Commission has failed, or refused, to cope with a growing problem in the natural gas producing industry. This case represents a typical example of that problem. The Commission is asking this Court to determine that it has no jurisdiction to deal with the problem, regardless of the merits of the producers' position.[1]

---

1. The Commission appears to concede that if the Court of Appeals is sustained, and it is required to give the producers a fair hearing on the merits, that individual relief "must be granted" in many cases, if not in this case, see Brief, p. 24, 25.

The problem arose in this way. Before gas exploration or development can begin, a company or an individual in that business normally obtains an oil and gas lease from the landowner. Such leases provide, in addition to a cash bonus to the lessor, that the lessor shall receive a percentage of either the proceeds received from the sale of gas by the lessee, or a percentage of the market value of the gas produced and sold from the lease. Absent regulation there was no material difference in the two provisions, as the lessee normally sold the entire gas stream at the market value.[2]

The belief that lessor was entitled to his royalty factor based on the price the lessee received for the gas[3] continued until the Commission's decision in the *Permian Basin Area Rate Proceeding,* 34 F.P.C. 159[4], decided August 5, 1965. In that proceeding the Commission rejected the producers' position that the ceiling rate should reflect, as nearly as could be estimated, the price which would be received in a free competitive market

2. The "market value" or "market price" was determined by reference to other sales of gas comparable in time, quality, and availability, *Phillips Petroleum Co. v. Bynum,* 155 F.2d 196 (5th Cir. 1946); *Texas Oil & Gas Corporation v. Vela,* 429 S.W.2d 866, 872 (Tex. S. Ct. 1968); *Arkansas Natural Gas Co. v. Sartor,* 78 F.2d 924 (5th Cir. 1935); *Shamrock Oil & Gas Corp. v. Coffee,* 140 F.2d 409 (5th Cir. 1944); *Sartor v. United Gas Public Service Co.,* 186 La. 555, 173 So. 103 (1937).

3. Which under State law the lessee was not only authorized, but obligated, to market the lessor's share of the gas, see *California v. Southland Royalty Co.,* ____U.S.____, 98 S.Ct. 1955, 56 L.Ed. 2d 505, slip op. p. 9 (1978); 5 H. Williams & C. Meyers, *Oil and Gas Law,* § 853 (1977); 2 Summers *Oil and Gas Law* § 415; *Brewster v. Lanyon Zinc Co.,* 140 F. 801 (8th Cir. 1905); Walker, *Property Interest Created By An Oil and Gas Lease,* 11 Tex. Law Rev. 399, 401.

4. Affirmed, *Permian Basin Area Rate Cases,* 390 U.S. (747 (1968).

(or the "market value") and instead based the ceiling rate on an industry-wide composite cost study for the producing area involved.

The interrelationship between the Commission-imposed ceiling rate and the market value royalty clause was first considered by a court in the companion cases of *Weymouth v. Colorado Interstate Gas Company,* 367 F.2d 84 (5th Cir. 1966) and *J.M. Huber Corporation v. Denman,* 367 F.2d 104 (5th Cir. 1966). In lengthy and lucid opinions by Chief Judge Brown, acting after *amicus* briefs had been filed by the Commission on request of the Court of Appeals, the Fifth Circuit held that as a matter of contract law the lessors were not confined to the ceiling rate established by the Commission for the lessee-producer, but that the lessors' royalty interest might also be subject to that ceiling rate. The cases were remanded to await the initial determination by the Commission whether it had jurisdiction over such interest, and if so, what type of filings were required by the lessors.

The Commission promptly instituted a proceeding to resolve this question, and on July 23, 1969 issued its Opinion No. 562 (42 F.P.C. 164), finding that it had jurisdiction over the price attributable to the royalty owner's share of the gas, and that he could not receive a price in excess of the just and reasonable rate regardless of his contract. The Commission also held that the royalty owner could receive a rate higher than the "filed rate" of the producer-lessee, if no ceiling rate was exceeded. The case was appealed to the District of Columbia Circuit, which reversed the Commission, holding that the royalty owner was not subject to Commission jurisdiction

because he had never made a "sale" of gas in interstate commerce, *Mobil Oil Corp. v. F.P.C.*, 463 F.2d 256 (D.C. Cir. 1972).

Shell Oil Company participated in the case before the Commission, arguing that even if the Commission could not assert jurisdiction over the royalty owner because no sale had occurred, the Commission could still fix the rate to which the royalty percentage would be applied for the reason that otherwise an unreasonable burden on interstate commerce would result, citing *United States v. Southwestern Cable Co.*, 392 U.S. 157 (1968) and *Northern Natural Gas Co. v. State Corporation Commission of Kansas*, 372 U.S. 84 (1962). The Commission relied on this argument as an "additional basis" for asserting jurisdiction.[5] The D.C. Circuit rejected this argument on the ground that:

> "The record simply does not focus on what may be involved in the possibility of recovery of royalty calculated on the basis of 'market prices' higher than ceilings." (463 F.2d 256, 264).

This Court denied certiorari, 406 U.S. 976 (1972).

While the *Mobil* case was pending in the D.C. Circuit on appeal, Mobil Oil Corporation sought relief on the market value royalty problem in two area rate cases then pending before the Commission, the *Southern Louisiana Area Rate Proceeding,* 46 F.P.C. 86 and the *Texas Gulf Coast Area Rate Proceeding,* 45 F.P.C. 674. In these cases, the Commission based its decision on a cost calculation which assumed that the producer would pay royalty on the basis of 14 (*Texas Gulf Coast Area

5. 42 F.P.C. at 172, 173.

Rate Proceeding, 45 F.P.C. 674, 842) to 15 (*Southern Louisiana Area Rate Proceeding,* 46 F.P.C. 86, 132) percent of price he received. Mobil appealed each of those cases on the grounds that the area ceiling rate failed to reflect any cost increment to compensate the producers for the market value royalty problem.

In each case the Court of Appeals rejected Mobil's argument on the grounds that the record did not contain sufficient evidence to enable the Commission to calculate a cost increment to compensate the producers for the market value, and the problem might not be sufficiently severe to merit treatment on an industry-wide basis, *Public Service Commission of New York v. F.P.C.*, 487 F.2d 1043, 1061 (D.C. Cir. 1973);[6] *Placid Oil Company v. F.P.C.*, 483 F.2d 880, 910-911 (5th Cir. 1973).

The issue was again raised by Mobil Oil Corporation in Petitions for Certiorari to this Court. This Court granted Mobil's Petition (and others) from the *Placid* decision, but affirmed the Commission and the Court of Appeals on this specific issue, *Mobil Oil Corp. v. F.P.C.*, 417 U.S. 283 (1974) stating:

> "We agree with the Court of Appeals that Mobil's argument is hypothetical at this stage and that *in any event an affected producer is entitled to seek individualized relief.*" (417 U.S. 283, 328) (Emphasis supplied)

In shifting from area rate regulation to nationwide ceiling rates, the Commission continued to base its ceiling rate on a cost study which calculated the producers'

6. Vacated and remanded on other grounds, *Shell Oil Co. v. Public Service Commission of New York*, 417 U.S. 964 (1974).

royalty cost as a percentage of the rate permitted to be charged, although the percentage was increased from 15 to 16 percent to reflect generally higher royalty percentages from offshore leases (*National Rate Case for New Gas,* Opinion No. 699, 51 F.P.C. 2212, 2272). Mobil and other producers, including Shell, continued to argue for a cost increment in the nationwide rate to reflect the market value royalty problem. In each case these arguments were rejected by the Commission; Opinion No. 699, Docket No. R-389-B, 51 F.P.C. 2212, 2272; 52 F.P.C. 1604; affirmed *Shell Oil Co. v. F.P.C.*, 520 F.2d 1061, 1068 (5th Cir. 1975), *cert. denied, sub nom. California Co. v. F.P.C.*, 426 U.S. 941 (1976); Opinion No. 749-C, ____F.P.C.____ (slip opinion p. 27) issued July 19, 1976; affirmed *Tenneco Oil Co. v. F.E.R.C.*, 571 F.2d 834, 848 (5th Cir. 1978).

It was in the context of this legal background that Shell and Pennzoil filed their Petitions for "individualized relief" described in Petitioners' Statement.

COUNTERSTATEMENT OF QUESTIONS PRESENTED

1. Whether the National Gas Act, as interpreted by this Court in *Federal Power Commission v. Texaco Inc.*, 417 U.S. 380 (1974), precludes the Commission from considering the fact that a producer may incur royalty costs substantially in excess of the percentage utilized by the Commission in establishing the ceilings applicable to the gas being sold from the leases in question, in a proceeding for individualized relief, for the reason that such royalty costs may be based in part on unregulated intrastate gas prices, along with other factors.

2. Whether the Commission is required by the Due Process Clause of the United States Constitution to address the question whether the producers' lease is being confiscated by refusal of the Commission to allow the producer a rate which is high enough to recover his costs, in *some* proceeding in which producers' rates are being determined, on either a national, area, individual company, or individual lease basis.

3. Whether, in a case before the Commission to grant abandonment of the royalty owners' percentage interest in the gas being sold in interstate commerce on the grounds that such abandonment is in the public convenience and necessity, the Commission can refuse to consider any issue other than the legal question whether, if the royalty owner is successful in canceling the lessee-producer's lease, that the lessor-royalty owner will be required to continue the sale in interstate commerce.

SUMMARY OF ARGUMENT

This proceeding represents the last chance for producers to obtain relief from confiscation of their leases through a chain of court decisions, detailed in the Statement, *supra,* which twisted the lease contract into a document never conceived of by the parties at the time the contracts were made. Step by step, the Commission has (i) fixed the lessee-producer's gas price at below market value; (ii) been found lacking in jurisdiction to fix the lessor's price at the same level; (iii) refused to consider or take into account this situation in calculating the royalty component of an area cost study used to calculate producer rates on an area basis; (iv) refused again to take this factor into account in making the same calcu-

lation on a national basis; (v) refused to calculate rates on the basis of individual producer company costs[7]; (vi) and finally, in this proceeding, asks this court to affirm that it has no jurisdiction to consider this issue in a specific proceeding brought for this purpose.[8]

This refusal to consider the question of increased royalty costs[9] occasioned by fixing ceiling rates below market value is made in the face of a clear direction by this Court in *Mobil Oil Corp. v. F.P.C.*, 417 U.S. 283, 328 (1974), that this is precisely the type proceeding in which this issue *should* be addressed.

The Commission's position rests primarily, if not totally, on an erroneous reading of this Court's opinion in *Federal Power Commission v. Texaco Inc., supra,* decided in the same term as *Mobil, supra.* The Commission reads *Texaco* as precluding the use of the market prices to determine the royalty component of producer costs, even though by contract the amount of royalty to be paid *must* be determined with reference to such prices. *Texaco* not only does not require such a result, it flatly holds that "market prices may be taken into account along with other factors" in determining producer rates, 417 U.S. 380, 399.

7. *Permian Basin Area Rate Cases,* 390 U.S. 747 (1968); Petitioner's Brief, page 18.

8. The Commission has also refused to consider this issue on a Petition for a Declaratory Order under Section 1.7(c) of the Commission's Rules (18 C.F.R. § 1.7(c)), see *Exxon Corporation,* Docket No. RI76-29, ____F.P.C.____, issued May 18, 1976, a copy of which is attached hereto as Appendix A.

9. As the Fifth Circuit held in *Placid, supra,* there is no question that "royalty obligations of the producers are cost components of the rate structure", 483 F.2d 880, 911. We do not understand the Commission to contend otherwise.

In remanding the case to the Commission for rehearing on the merits, the Court of Appeals did not require the Commission to find for the producer. The Commission was merely required to consider the merits of the producers' position, after giving them an opportunity, on a reopened record, to attempt to prove their case. The Commission is apparently unwilling to accept that result because it indeed believes that so many producers are incurring such additional costs as to affect the national average royalty figure, or that it cannot refuse to provide individualized relief to many producers if it ever fairly considers the issue (Brief, pp. 23-25). The Commission did not consider the evidence of economic hardship (*i.e.*, costs versus revenues) in the record in arriving at its decision, as it concedes (Brief, p. 9). Therefore, the supporting arguments of counsel, to the effect that Shell could still make a profit and pay the higher royalty cost (p. 34), or the possibility that Shell and Pennzoil may yet prevail in the State Court action against the lessor (pp. 35, 36) need not be considered by this Court, as they were not considered by the Commission below.

On the alternative relief proposal for the granting of abandonment authority on the percentage of the gas attributable to the lessor's interest, the Commission takes the positic. that reversal by this Court of the Fifth Circuit decision in *Southland Royalty Co. v. F.P.C.*, 543 F.2d 1134 (1976), in *California v. Southland Royalty Co.*, ___U.S.___, 98 S.Ct. 1955, 56 L.Ed.2d 505 requires reversal on this issue. While we concede that the grounds on which the Court of Appeals reversed the Commission are no longer present, this does not mean the Commission can look only at one narrow facet

of the public convenience and necessity, ignoring all other considerations affecting both producer and consumer. The case should be remanded on this issue as well, for a full consideration of *all* factors affecting the public convenience and necessity.

ARGUMENT

I. The "Basic Principles Of Rate Regulation" Require, Rather Than Preclude, The Commission To Hear The Petitions Of Shell And Pennzoil For Special Relief On The Merits.

A. The Basis Of The Commission's Decision.

On the question whether the producers are entitled to a hearing on their Petitions for Special Relief, the Commission's decision rests on very narrow grounds. Those grounds, set forth in Opinion No. 753, at pages 453 and 454 of the record (A. pp. 260, 261) and reiterated in Opinion No. 753-A (A. pp. 291-293) are summarized in the following sentence:

> "The Commission does not have the power to base a part of the regulated price [i.e., the royalty cost component used to determine the regulated price] on the unregulated market value of intrastate gas." (A. p. 293)

This is true, says the Commission[10], even where, as as in this case, the royalty cost component is *not based solely* on the "unregulated market value of intrastate gas" but is based on a number of other factors, including

10. Brief, pp. 4, 28.

the Commission's ceiling rates[11], a desire to settle State Court litigation which could result in even higher royalty costs[12], and a desire to clear the cloud on title caused by the *Williams*' lawsuit, so that the lease could be further developed to obtain additional gas for United's customers.[13]

Conceding that royalty costs are only one component of the producers' ceiling rate, the Commission says that *this component* cannot be used because it is based on price which the Commission does not regulate.

The fallacy in this reasoning was exposed by the Court of Appeals below.[14]

> "Determination of the reasonableness of a cost necessarily requires consideration of a market price. In all probability, the reasonableness of a great many costs of gas production must be determined by the prevailing market price in an uncontrolled market. The Commission has failed to suggest why royalty costs in an uncontrolled market are any different than any other cost." (Op., p. 7a; Br., p. 29)

The Commission attempts to justify its position on the basis that the royalty costs are different from other unregulated costs because they are based on unregulated gas prices (Br., p. 29). The short answer to the Commission's position is that Congress did not authorize

11. Appendix, pp. 44, 64, 65.

12. Brief, p. 4; Appendix, p. 56, 72-74, 119-121, 160-161.

13. Appendix, p. 47, 48, 67.

14. The Court of Appeals' Opinion appears as Appendix A to the Petition for Certiorari. Pages of the Court of Appeals' Opinion are cited by the pagination in that Appendix, *i.e.*, Op. p. 1a, etc.

it to regulate intrastate gas prices any more than it authorized it to regulate the cost of steel drill pipe. The Commission always has the power, specifically recognized the Court of Appeals in the sentence preceding the quoted language above (Op., p. 7a) to consider the reasonableness of the cost occurred. The problem here is that the Commission *refuses to hold a hearing where the reasonableness of such costs can be considered,* because it is afraid it may indeed be forced to find these costs to be reasonable (Br., p. 25).

This is not the first case in which the Commission has considered unregulated intrastate prices in determining the reasonableness of producer rates. In *Shell Oil Co. v. F.P.C.* (*Other Southwest Area Rate Case*), 484 F.2d 469 (5th Cir. 1973), *cert. den. sub nom. Mobil Oil Corporation v. F.P.C.*, 417 U.S. 973, the Court of Appeals upheld the Commission's consideration of intrastate prices as "one of the relevant factors" in determining interstate rates, 484 F.2d 469, 479.

In the first national rate proceeding, the Commission again considered a comparison of its rate structure with intrastate prices and was sustained in so doing by the Courts, *Shell Oil Co. v. F.P.C.*, 520 F.2d 1061, 1083-84 (5th Cir. 1975), *cert. den. sub. nom. California v. F.P.C.*, 426 U.S. 941 (1976). The Court of Appeals (Fifth Circuit) held that although the Commission could *utilize* a comparison with intrastate prices, it could not place "*exclusive reliance*" on such prices in determining the ceiling rate, citing this Court's decision in *Texaco, supra.*

In fact, the Commission has promulgated a special form, Form No. 45, to collect intrastate pricing data for

use in determining producer rates, and successfully defended this procedure in the Court of Appeals, see *Continental Oil Co. v. F.P.C.*, 519 F.2d 31 (5th Cir. 1975), *cert. den., sub nom. Superior Oil Co. v. F.P.C.*, 425 U.S. 971 (1976).

B. The Holding Of *F.P.C. v. Texaco Inc.*[15]

The Commission's conclusion quoted above rests principally, if not totally, on its construction of *Texaco*. A careful examination of that decision is therefore warranted.

In *Texaco*, the Commission attempted to effectively "deregulate" small producers[16] (417 U.S. at 383), by exempting them from all filing requirements and rate ceilings prescribed in the Natural Gas Act and the Commission's Rules for other producers, and to place the burden on the pipeline purchaser of such producer not to pay an "unreasonable" rate, on the penalty of having a portion of their purchased gas cost component in the pipeline cost-of-service disallowed in a future pipeline rate case.[17]

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15. 417 U.S. 380, 94 S.Ct. 2315, 41 L.Ed.2d 141.

16. "Small producer" was defined as an independent producer, unaffiliated with a natural gas pipeline company, whose total jurisdictional sales did not exceed 10,000,000 Mcf per year, 417 U.S. at 383, 45 F.P.C. 454.

17. Although the *Texaco* opinion speaks throughout of purchases from small producers by large producers, as well as by gas pipelines, the burden of the indirect regulation fell almost entirely on the pipelines, not the large producers. Both large and small producers normally sell gas to interstate pipeline companies, which are regulated on an individual company cost-of-service basis by the Commission. Interstate pipelines are the only purchasers who are entitled to recover a "cost of purchased gas" on a cost-of-service basis. Large producers operate gas processing plants in some areas of the

The Commission's Order was challenged in the Court of Appeals by pipeline companies (Tennessee Gas Pipeline Company, the Independent Natural Gas Association of America (an association of pipelines) and Consolidated Gas Supply Corporation), large producers (Texaco Inc., Phillips Petroleum Company and Warren Petroleum Company), the Public Service Commission of New York, (representing the consumer interest), and one small producer, James Forgotson, Sr. The D.C. Circuit held that the practical effect of the Commission's Order was to exempt one class of producers from regulation, which it had no authority to do, and reversed the Commission, *Texaco Inc. v. F.P.C.*, 474 F.2d 416 (1972).

This Court reversed the Court of Appeals and sustained the Commission on the question whether the Commission had the power to indirectly regulate the small producers by regulating the rate of the pipeline purchaser (417 U.S. at 387-393), but affirmed the Court of Appeals' conclusion that the Commission could not relieve the small producer from his obligation under the Natural Gas Act not to sell his gas in interstate commerce at more than the just and reasonable rate (417 U.S. at 394).

The Commission contended that its Order No. 428 did require a finding that the small producers' rate was "just

country, notably the Texas Panhandle and Permian Basin, where they purchase gas from small producers in the field and resell the gas to an interstate pipeline at the plant tailgate after removing the liquid hydrocarbons. As large producers are *not* regulated on an individual cost-of-service basis, continuation of these plant operations depends on the Commission's permission to sell the gas to the interstate pipeline at a rate at least equal to the rate they are permitted to pay the buyer. But in no sense is the small producers' sale price considered a "cost" for rate purposes in determining the large producers' rate.

and reasonable", because it required the pipeline purchaser to reduce its sales price to exclude that portion of the small producer price "which is *unreasonably* high considering appropriate comparisons with higher contract prices for sales by large producers or the prevailing market price for intrastate sales" (417 U.S. at 396). Upon consideration of this language in the Order, this Court concluded that the *only* basis for a determination of the "reasonableness" of the price was a comparison to the marketplace standard. Assertions by Commission's counsel that the Commission would consider *other* "relavant factors" were rejected as post hoc rationalizations of counsel, see 417 U.S. at 397, citing *Burlington Truck Lines v. United States,* 371 U.S. 156, 168-169 (1962) and *S.E.C. v. Chenery Corp.*, 332 U.S. 194, 196 (1947). Significantly, this Court said at that point in the Opinion:

> "Had the order unambiguously provided what the Commission now asserts it was intended to provide, we would have a far different case to decide." (417 U.S. at 397). (n. omitted)

Then appears the language quoted by the Commission and relied on at page 20 of its Brief. The Commission's error lies in reading this language, in which the Court clearly states that the market price cannot be the "final measure" (417 U.S. at 397) or the "conclusive" determinant (417 U.S. at 399) or the "exclusive reliance" (417 U.S. at 400) as meaning that the Commission cannot utilize or rely at all on market prices for *any cost component* of the total rate permitted to be charged by the producer, even though it retains the power to examine this cost component for reasonableness, and even though this cost component is determined in part with reference

to other factors, and even though many other considerations enter into the final rate determination.

The Commission's interpretation is clearly foreclosed by the following language by the Court:

> "This does not mean that the market price of gas would never, in our individual case, coincide with the just and reasonable rates or not be a relevant consideration in the setting of area rates, see, Permian Basin Area Rate Cases, 390 U.S. at 793-795; 20 L.Ed.2d 312; *it may certainly be taken into account along with other factors,* Southern Louisiana Area Rate Cases, 428 F.2d 407, 441 (CA 5) cert. denied, sub nom. Associated Gas Distributors v. Austral Oil Co., 400 U.S. 950, 27 L.Ed.2d 257, 91 S.Ct. 241 (1970)." (417 U.S. at 399) (Emphasis supplied).

In this case, the settlement which the Commission was asked to approve did not place "exclusive reliance" on the intrastate market price as a determinant of the royalty cost to be flowed through to the pipeline. The price on which the royalty percentage would be based was 78 cents per Mcf plus an escalation of 1.5 cents per Mcf per year, or 150 percent (later reduced to 100%, see Pennzoil's Brief in Opposition to Petition for Certiorari, p. 4, n. 4) of the applicable ceiling rate determined by the Commission, whichever was higher. If the Commission in a later proceeding increased the ceiling rates (31.11 cents and 59.88 cents in 1975, Br., p. 4) applicable to this sale, above the 78-cent level, then the Commission's ceiling rate would control without any reference to the intrastate market price. More importantly, if the intrastate market price increased above 78 cents, plus 1.5 cents per year, the royalty would still be based on the 78-cent price. According to the evidence in the record, this has in fact occurred. In the State Court action Williams was contending the market price had reached $1.40 per Mcf by January 1, 1975 (A., p. 44). Mr. Lamar Smith, witness for the purchaser, United Gas Pipe Line Company, testified that by July 1975 the unregulated market price in South Louisiana was "well above $1.50" per Mcf (A., p. 56). Mr. Smith cited a number of contracts which his company had entered into in this area for non-jurisdictional gas at prices ranging from $1.0804 per Mcf to $1.5786 per Mcf (A., pp. 57, 58). The most recent publication by the Commission shows the average new contract price in Southern Louisiana to be $1.949 per Mcf for the first quarter[18] of 1978. It is readily apparent that the 78-cent price is a compromise figure arrived at to settle a lawsuit, and is not based *entirely* on unregulated prices.[19]

C. Other "Basic Principles Of Rate Regulation" Require Affirmance Of The Court Of Appeals.

One of the most basic principles of rate regulation is that the regulated company be afforded some forum to show the reasonable costs which it has incurred, and if the rate to be charged is to be based on costs as the Commission has insisted, that *some* adjustment or provision be made for the recovery of those costs. In making this assertion, Shell is not arguing the merits of an indi-

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18. Publication is attached hereto as Appendix B, see pp. 22, 23 *infra*.

19. Contrary to the Commission's implication (Br., pp. 21-22), the price on which the royalty is calculated under the settlement with the royalty owners, 78 cents plus 1.5 cents annual escalations, does not "fluctuate" with further increases in the intrastate market price. This is the principal advantage when Shell and Pennzoil, as well as United and its customers, derive from the settlement.

vidual company or individual project cost basis for rates as opposed to area or national rates, as the Commission implies (Br., p. 33). The point is, that the Commission has already *expressly refused* to consider this type of cost in area and national rate proceedings, and its refusal has been affirmed by the Court of Appeals and this Court, *Placid Oil Co. v. F.P.C.*, 483 F.2d 880, 910-911 (5th Cir. 1973), affirmed *Mobil Oil Corp. v. F.P.C.*, 417 U.S. 283, 328; Opinion No. 749-C, ____ F.P.C. ____, issued July 19, 1976, slip opinion, p. 27 affirmed *Tenneco Oil Co. v. F.E.R.C.*, 571 F.2d 834, 848 (5th Cir. 1978); Opinion Nos. 699 and 699-H, 51 F.P.C. 2212, 2272, 52 F.P.C. 1604, affirmed *Shell Oil Co. v. F.P.C.*, 520 F.2d 1061, 1068, *cert. den. sub nom. California Co. v. F.P.C.*, 426 U.S. 941 (1976).

Having made the decision *not* to consider the question of additional royalty costs incurred by producers in an area or national rate decision, if the Commission has no power to consider the question in a proceeding for individualized relief as it insists, the producer is left without *any proceeding at all* in which this issue will be considered.

The error of the Commission's position is made even clearer by reference to the language used by this Court, and by the Fifth Circuit, in affirming this Commission's earlier decision *not* to consider this issue in an area rate case. This Court said:

> "We agree with the Court of Appeals that Mobil's argument is hypothetical at this stage and that in any event an affected producer is entitled to seek individualized relief. The Court of Appeals said:
>
> '. . . we are not willing to alter or stay the implementation of area wide rates for the entire industry merely on the basis of what *might* happen to *some* producers' costs if the [D. C. Circuit's] statement of the law prevails.
>
> 'If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief. Permian contemplated it.' 483 F.2d, at 911 (italics in original)." 417 U.S. at 328)

The Commission's attempt to avoid the clear instruction of this Court in *Mobil* is difficult to follow and impossible to understand (Br., pp. 30-32). The Commission launches into a discussion of whether the special relief should be granted *in the hearing for individualized relief* ordered by the Court. The fallacy in that discussion is that in this case, *no such hearing has ever been held*. The truncated and high pressure proceeding[20] which the Commission ordered on this issue was disregarded by the Commission in reaching its decision, *because it found it had no jurisdiction even to consider the issue* (Br., p. 34). All the Court of Appeals did was remand this issue to the Commission *for a decision on the merits* (Op., A. p. 8a). The Court is not being asked to review a decision by the Commission on the merits of the question whether the producers have incurred a cost which is unreasonable and should not be flowed through to the pipeline. The Court is instead being asked by the Commission to find that it *has no jurisdiction to hold a hearing* to determine whether these costs are unreasonable or not! The Court of Appeals was clearly correct in remanding the case to the Commission for consideration of this issue.

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20. The nature of the hearing before the Commission is discussed further at pages 23, 24, *infra*.

D. The Record Shows That Without The Relief Requested, Shell's Leases Will Be Confiscated.

Although conceding that the Commission's decision rested entirely on jurisdictional grounds (Br., p. 34), Petitioner proceeds to make three further arguments against Shell's position. These are: (i) there is no reason to impose a higher rate on consumers because of an improvident contract made by Shell and Pennzoil (Br., p. 22, n. 12); (ii) Shell could absorb the higher royalties and still make a profit on its leases (Br., pp. 7-8, 34); and (iii) Shell and Pennzoil may prevail in the State Court litigation against the lessor, so the Petition for Special Relief is premature and possibly unnecessary. (Br., pp. 35-36). We will answer these points *seriatim*.

1. Shell's Lease Contracts Are Not "Unreasonable" Or Improvident.

At several places in its Brief (pp. 18, 22, n. 12), the Commission refers to the rule that it is not required to flow through a producer cost which results from an "excessive or unreasonable" (p. 18) contract made by the producer. As the Commission has made no such finding, this argument cannot support reversal of the Court of Appeals' decision directing the Commission to hold a hearing to address this very question (Op., A. p. 7a). However, a short discussion of the issue is appropriate in light of the Petitioner's implication.

If Shell were to enter into these lease contracts today, with the knowledge of the decisions set out in the Statement, *supra*, it could well be contended that the contracts were improvident and it must absorb any additional costs resulting therefrom.[21] But the leases involved here were entered into on August 29, 1934, before the Natural Gas Act was passed, and July 24, 1952, before this Court's decision in *Phillips v. Wisconsin*, 347 U.S. 672 (1954). Shell had no reason to suspect at the time these leases were obtained, that the royalty percentage set out in those leases would be calculated on any price which would be different than that price received for the sale of the gas, despite the use of the terms "market value" and "market price". The royalty percentages (1/8th and 1/4th) conformed with the industry practice in the area at the time, and were necessary in order to purchase the leases. On these facts, it is apparent that any holding by the Commission that the royalty provisions of these leases were "excessive or unreasonable" would be arbitrary and capricious.

2. If The Requested Relief Is Denied, Shell Faces Confiscation Of Its Leases.

The Commission would lead the Court to believe that Shell can absorb the additional royalty required to be paid if it loses the State Court case with the lessor, and still make a profit on these leases (Br., pp. 7-8, 34). This is incorrect.

The $290,000 annual profit figure calculated by the Administrative Law Judge is based on the 78 cents per Mcf price in the settlement agreement. If the Commission denies the relief requested, there is no settlement, and Shell must proceed with the State Court action

21. Except in the case of leases from State or Federal Governments, where the lease forms are prescribed by law.

against the lessor. If the lessor prevails, the royalty will be based on current intrastate prices.

The royalty owner contended that the market value, based on intrastate price in 1975, was $1.40 per Mcf (A. p. 137). If the royalty owner's position prevails in the State Court, Shell would be required to pay out as royalty 35 cents per Mcf under the 1952 lease. The record establishes that Shell would owe 5.25 cents per Mcf to the State of Louisiana for severance taxes, and incur 4.5 cents per Mcf as operating costs, which were uncontested by any party and accepted by the Law Judge (A. 137-138, 178). The revenue realized by Shell under Commission ceiling rates on the 1952 lease was 41.6 cents per Mcf. Thus, Shell would lose 3.15 cents for each Mcf of gas produced from this lease, should the lessor prevail (A. 137).

The royalty cost will increase as the "market value" of the gas increases. According to the recent report issued by the Office of Pipeline and Producer Regulation in May 1978,[22] the average price received in Louisiana for new intrastate contracts for the first quarter 1978 was $1.949 per Mcf, and the highest new contract price was $2.14 per Mcf. Therefore, there is basis for a finding by the State Court that the "market value" or "market price" is currently $1.95 per Mcf. Under *Texas Oil & Gas Corporation v. Vela,* 429 S.W.2d 866, 871 (Tex. Sup. Ct. 1968), the "market price" to which the royalty is applied is

22. A copy of the press release, cover sheet, and the page dealing with Louisiana intrastate prices, are attached hereto as Appendix B.

determined on the day the gas is delivered to the purchaser, not the time the contract is entered into.

The Law Judge included $112,664 annual condensate revenues as an offset against operating costs (A. 179). These revenues would be more than offset by the damages owed to lessor for failure to pay past royalties based on market prices. While these damages cannot be quantified down to date, as of April 30, 1975 they were $197,689.49, assuming the lessor prevails in the State Court case (A. 68). For the period after April 30, 1975, these damages would be substantially higher, because of the rapid escalation in intrastate prices.

We would note again that the cost-revenue comparison shown above involves only current operating costs, and contains no allowance for amortization of capital investment, return on that investment, or federal income taxes. This is not because such costs were not incurred by Shell - obviously, wells had to be drilled to produce the gas in question. Instead, this was a result of the manner in which the hearing was conducted by the Commission. Initially the Commission denied Shell's Petition for Special Relief summarily, and ordered a hearing only on the abandonment issue (A. 32-36). Applications for Rehearing were filed, and on the day Shell's counsel appeared at the hearing he was advised that the Commission had reversed its position and ordered a hearing on the special relief question also (A. 37-39). Shell was given a sharply limited time period within which to file cost evidence, because the hearing was being held on an expedited basis. Because these leases are included in ten separate units involving other owners and other lands, which differ in configuration due to

the reservoir involved, the cost calculation is extremely complex (see tabulations and map at A. 151-155). There simply was not time to develop a cost study showing capital investment, return, income taxes, etc. (A. 69-71) applicable to these leases and their share of the respective units.

Moreover, the Commission gave no clear direction of what cost evidence it desired, or what use, if any, it would make of such evidence.[23] The Commission's convening orders merely refer to "overall costs higher than those set forth in Opinion 699-H" (A. 34, 37) without indicating whether these costs are to be computed on a lease, company, area, or national basis. In response to a specific question, Staff counsel was equally ambiguous (A. 70). Faced with this uncertainty, Shell used the nationwide costs used by the Commission in Opinion No. 699-H, substituting the specific lease costs for operating expenses and royalty developed on this record.[24] These studies showed total costs substantially above revenues for both leases, even considering the liquid revenue credit (A. 139-140). This approach was rejected by the Law Judge (A. 177-178).

Before the Commission can reject Shell's Petition for Special Relief on a cost basis, Shell is entitled to the reasonable opportunity to present cost evidence after being informed what type of evidence is required.

23. The Commission's final order disregarded the record entirely.

24. This method had been approved by the Commission in other cases as an acceptable way of determining costs, see Order No. 455, affirmed *Moss v. F.P.C.*, 502 F.2d 461 (D.C. Cir. 1974), affirmed *F.P.C. v. Moss*, 424 U.S. 494 (1976).

3. If The State Court Settlement Is Destroyed By Refusal Of The Commission To Grant Relief, There Is Substantial Risk That The Lessor May Prevail.

We agree with the Commission that the State Courts of Louisiana have not resolved the question whether under a "market value" lease the lessor is limited to a royalty based on the price received by the lessee for the gas (Br., p. 5, n. 4).[25] The *Huber* and *Weymouth* cases discussed *supra*, page 3, hold for the lessor. In *Texas Oil & Gas Corporation v. Vela, supra,* the Texas Supreme Court resolved the issue squarely in favor of the lessor, see also *Butler v. Exxon Corp.*, 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977); *Kingery v. Continental Oil Co.*, 434 F.Supp. 349 (W.D. Tex. 1977); *Brent v. Natural Gas Pipeline Co. of America*, ____F. Supp.____ (N.D. Tex., Civil Action No. CA-2-75-167, August 1978).

The issue was also resolved in the lessor's favor by the Supreme Court of Kansas in *Lightcap v. Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1 (1977), *cert. denied Mobil Oil Corp. v. Lightcap*, 434 U.S. 876, petition for rehearing pending, Case No. 76-1694.

Therefore, while the issue has not been resolved in Louisiana, the lessor has prevailed on this issue in Texas and Kansas, two major gas producing states, and also in the United States Court of Appeals for the Fifth Circuit. It therefore cannot be said that there is no merit to the lessor's position.

25. *Whitehall Oil Co. v. Boagni*, 255 La. 67, 229 So.2d 702, 704-05 (1969) does contain dicta favorable to the lessee's position. However, as the Commission concedes, this was not the issue decided by the Court.

II. The Case Should Still Be Remanded To The Commission On The Abandonment Issue, Even Though The Fifth Circuit's *Southland* Decision Has Been Reversed.

A. What Does The "Public Convenience And Necessity" Require?

Section 7(b) of the Act, quoted by the Commission at page 38, prohibits abandonment of service unless the Commission finds "that the public convenience and necessity permit such abandonment". In support of its position that the public convenience and necessity favored abandonment as to the lessor's percentage share of the gas stream, Shell made the following arguments:

1. Should the lessor prevail in his State Court action, Shell was faced with the loss of its lease, including its entire capital investment, rights to future production, and liability in damages for prior underpayment of royalties, either by order of the court for breach of contract, or by the establishment of a royalty which was so high as to make further operation of the lease uneconomic, therefore causing expiration of the lease by its terms. This would amount to confiscation of Shell's leasehold estate by regulatory action.

2. Should the lessor prevail, and Shell's leases terminate, the entire gas stream, not merely one-eighth (1/8th) of one-fourth (1/4th) of the gas, would be lost to United and the interstate consumer.

3. Assuming *arguendo* that Shell is in error on Point 2, United Gas Pipe Line Company and its

interstate customers would still suffer a detriment if Shell's leases are terminated, though:

(a) Loss of additional gas supplies obtained by additional wells planned by Shell and Pennzoil which would never be drilled.

(b) Higher prices paid to the lessor because of his status as a small producer, and the rate structures adopted by the Commission.

The Commission did not address Shell's first and third contentions in either of its Opinions, its Briefs to the Court of Appeals, or its Brief here. It dealt only with the second issue, relying on its decision in *El Paso Natural Gas Co.*, Opinion No. 737. As the Commission explains (Br., pp. 37-41), the Fifth Circuit reversed this decision in *Southland Royalty Co. v. F.P.C.*, 543 F.2d 1134 (1976), and relied on that reversal to reverse the Commission below (Op., p. 9a). Shell concedes that the grounds for reversal relied on by the Court of Appeals was wiped out by this Court's opinion in *California v. Southland Royalty Co.*, ____ U.S. ____ 98 S.Ct. 1955, 56 L.Ed.2d 505 (1978). But this does not mean that the case should not be remanded to the Commission on the abandonment issue as well.

B. The "Investor" Interest Is Entitled To *Some* Consideration.

The statutory determination whether abandonment is in "the public convenience and necessity" rests on a broader base than merely the question of whether failure to grant abandonment could occasion loss of the entire gas stream to the interstate market. All major decisions

by this Court enjoin the Commission to consider the "end results" of its actions, and to "balance both investor and consumer interests", see *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *Permian Basin Area Rate Cases*, 390 U.S. 747, 770 (1968); *Mobil Oil Corp. v. F.P.C.*, 417 U.S. 283, 307 (1974); *F.P.C. v. Texaco*, 417 U.S. 380, 388-389 (1974).

If the "end result" of the Commission's action in denying abandonment is complete destruction of the investor interest, it is difficult to see how that interest has even been considered, much less balanced against the consumer interest. The granting of abandonment on the lessor's interest merely means that this gas will be sold on the intrastate, rather than the interstate market. There is no finding, or any basis for a finding, that public policy favors the interstate consumer over the intrastate consumer.

As discussed at page 22, *supra*, on one of Shell's two leases the total revenue is already exceeded by operating expenses, State taxes, and lessor's royalty, if the lessor prevails in the State Court. If the trend in increasing market prices continues, the other lease will shortly be in this posture. There is no question that affirmance of the Commission will place Shell squarely at the mercy of the State Court action against the lessor. This Court has held that the Commission cannot fix confiscatory rates, *California v. Southland Royalty Co.*, ____U.S.____, 98 S.Ct. 1955, 56 L.Ed.2d 505, slip opinion p. 8; *F.P.C. v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942); *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591, 602-603 (1944).

C. Where Lies The "Consumer" Interest?

The Commission concludes that under this Court's opinion in *California v. Southland Royalty Co.*, *supra*, should Shell's lease terminate the lessor will be required to continue the sale to United Gas Pipe Line Company, and therefore its inquiry into the merits of abandonment is at an end. The Commission has not considered, and if affirmed by this Court will never consider, the impact on the consumer that would result from the termination of Shell's lease.

This Court in *Southland* found that the service obligation to continue the sale of gas in interstate commerce continued until the Commission granted abandonment, even though the leasehold estate had terminated. But it did not hold that the lessor was bound by the *contract to sell gas* entered into by the lessee. Indeed, the thrust of the Court's opinion is that the service obligation controlled over private contractual arrangements. At page 7 of the slip opinion, the Court said:

> " . . . [T]he Act is concerned with the continuation of 'service' rather than with particular sales of gas or contract rights."

Therefore, as we read *Southland*, the lessors would be obligated to continue the sale to United, but would not be bound by the *contract* entered into between Shell and United. Thus, the lessors would be entitled to enter into a "replacement contract" with United. Under the rate structure set up by the Commission in Opinion No. 699-H[26] and reaffirmed in Opinion No. 770-A, affirmed

26. Affirmed *Shell Oil Co. v. F.P.C.*, *supra*.

American Public Gas Association v. F.E.R.C., 567 F.2d 1016 (1977), *cert. den.*, ____U.S.____, 55 L.Ed.2d 499, the ceiling applicable to this "replacement contract" would be the 59.88-cent rate authorized in Opinion No. 699-H (A. 42, 67). Thus, instead of paying the prices paid to Shell under present ceilings of 39.0 cents on the 1934 lease (A. 136) and 41.6 cents on the 1952 lease (A. 136). United's customers would have to pay 59.88 cents per Mcf for the *entire gas stream.*

There is a strong probability that the lessor could qualify for an even higher rate. In Order No. 568 issued July 14, 1977, __F.P.C.__, the Commission held that a "small producer"[27] was entitled to a higher just and reasonable rate than a large producer, specifically 130 percent of the base ceiling rate established in Opinion No. 699, *et seq.* (18 C.F.R. 157.40(c) (1)). Therefore, if the Williams qualify as "small producers" they will be entitled to a ceiling rate of 74.96 cents (52¢ x 130% = 67.6¢, plus Btu and tax adjustments of approximately 7.36¢) for the entire gas stream.[28] Thus, the consumer will suffer substantial price *increases* if Shell's leases terminate, because of the different rate structures established by the Commission.

Nor is it likely that the consumer will suffer any decrease in supply if abandonment is granted on the lessor's interest. While the percentage of the current production going to the interstate consumer (but not the overall market, as the intrastate consumer would receive these supplies) would be decreased by one-eighth

27. Defined as a producer selling less than ten million Mcf per year in interstate commerce.

28. This compares with 42.6¢ and 50.6¢ per Mcf paid to Shell if the special relief were granted, A. 136.

(1/8th) and one-fourth (1/4), respectively, the total supply of the gas is likely to increase. This is true because both Shell and Pennzoil have indicated additional wells may be drilled on these leases if this litigation can be resolved in accordance with the terms of the settlement with the lessor (A. 47, 48, 67). There is no evidence that the lessor has the capital, or the inclination, to do any additional drilling. If Shell and Pennzoil are allowed to proceed with their plans free of the cloud created by this litigation, it is likely that the supply of gas to the interstate consumer may be increased, not decreased.

On this issue also, this Court's review is premature because the Commission never considered the impact of denying abandonment on the producers, the intrastate consumers, or the interstate consumers. It considered *only* the narrow question whether this gas must continue to be sold in interstate commerce if Shell's and Pennzoil's leases terminated. The case should be remanded to the Commission on the abandonment issue also, with instructions to consider *all aspects* of the "public convenience and necessity".

CONCLUSION

This case is prematurely before this Court, as the Commission has not considered either of the two types of relief requested on the merits. There is no prohibition, either in the Act or this Court's *Texaco* decision which preclude this consideration by the Commission. The

Court of Appeals' decision remanding this case to the Commission should be affirmed.

Respectfully submitted,

/s/ THOMAS G. JOHNSON

THOMAS G. JOHNSON
Attorney for
SHELL OIL COMPANY

October 5, 1978

APPENDIX A

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION
DECLARATORY ORDER—ROYALTY

Before Commissioners: Richard L. Dunham, Chairman; Don S. Smith, John H. Holloman III, and James G. Watt.

Exxon Corporation — Docket No. R176-29

ORDER GRANTING INTERVENTION AND RESPONDING TO PETITION FOR A DECLARATORY ORDER

(Issued May 18, 1976)

On September 18, 1975, Exxon Corporation (Exxon) filed a petition for declaratory order pursuant to Sections 4, 7, 14, and 16 of the Natural Gas Act[1] and Section 1.7 (c) of the Commission's Rules of Practice and Procedure.[2] The petition requests the Commission to answer certain questions, hereinafter discussed, which relate to pending litigation between Exxon and certain lessors regarding the sale of natural gas in interstate commerce for resale. 27 parties filed petitions to intervene (Appendix A) and 9 parties filed untimely petitions to intervene (Appendix B).

Exxon's question and our answers are as follows:

---

1. 15 U.S.C. §§ 717c, f, m and o.

2. 18 C.F.R. § 1.7(c).

1. Will the Commission declare that its applicable just and reasonable ceiling rates, or a producer's effective rate, are the "market prices" for purposes of meeting royalty obligations under leases from which gas is produced and sold in interstate commerce?

The Commission's jurisdiction over royalty payments by producers to lessors was rejected by the Court in *Mobil Oil Corporation v. F.P.C.*, 463 F.2d 256 (D.C. Cir. 1972), *cert. den'd*, 406 U.S. 976 (1976). The Court held that although the Commission had jurisdiction over rates charged by a producer, it had no jurisdiction over the rate utilized in computing the royalty payment. Accordingly, the above contract question posed by Exxon would be one for the appropriate court to decide. The court in *Mobil* mentioned the possibility that, "[T]he court handling the contract clause could avoid becoming embroiled in the ascertainment of the Federal ceiling by referring the issue to the FPC." (*Mobil* at 265). However, as intervenors Jane Alida Baugh Beard *et al.* have correctly pointed out, it is only upon proper reference from the court handling such a contract clause that we could become involved, to any extent, in the contract issue. That not being the case here, we decline further comment.

2. Will the Commission allow the automatic adjustment of a producer's applicable ceiling rate when that producer shows that it is required to pay a royalty to its lessor(s) on a basis higher than such applicable just and reasonable rate?

Recently, in Opinion No. 753[3] we discussed this issue

3. Pennzoil Producing Company and Shell Oil Company, Opinion No. 753 (Issued January 30, 1976); Opinion No. 753-A (Issued February 27, 1976); Opinion No. 753-B (Issued March 26, 1976).

in the context of a proposed settlement agreement regarding royalty payments between the lessors-royalty owners and lessees-producers. We stated there that a producer is always at liberty to compute royalty payments on the basis of a rate in excess of the ceiling rate, but that if he "attempts to flow this cost through to the pipeline and ultimately to the consumer, we must determine if this *incremental royalty cost* is just and reasonable." (Opinion No. 753 at 6). We held that incremental royalty costs could not be based on any other factors than the just and reasonable rate, citing *F.P.C. v. Texaco.*[4] The foregoing discussion was specifically with reference to the proposed settlement agreement therein in issue. As we noted in both Opinion Nos. 753-A and B, our conclusions were not based upon the existence of a state court judgment and our reference in Opinion No. 753 at page 7 to such judgments is indeed dicta.

In light of our response to this question, additional comments on questions 3 and 4 are unnecessary.

5. If the answers to questions 1 through 4. above are "No", will the Commission permit the abandonment of the fractional portion of gas reserves dedicated to a contract attributable to the royalty interest in the event than the lessee-producer is required to pay royalties on a basis higher than the just and reasonable ceiling rate applicable to such gas?

This precise issue was raised in connection with the alternative application for abandonment filed by Pennzoil and Shell in Opinion 753. In that case we denied the request for abandonment finding neither that the gas supply had been depleted to the extent that the continuation

4. *FPC v. Texaco, Inc.*, 417 U.S. 380 (1974).

of service was unwarranted or that the present or future public convenience or necessity required authorization of abandonment. We will not permit abandonment of the royalty gas merely because a producer is required to pay royalties on the basis of a rate above that which the producer is entitled to collect under the Natural Gas Act.

The Commission orders:

(A) Good cause exists to grant intervention in these proceedings to those parties listed in Appendix A and B, subject to the rules and regulations of the Commission; *Provided, however,* that participation of such intervenors shall be limited to matters affecting asserted rights and interests as specifically set forth in the petitions to intervene; and *provided, further,* that the admission of such intervenors shall not be construed as recognition by the Commission that they might be aggrieved because of any order of the Commission entered in these proceedings.

(B) The questions raised in Exxon's petition are answered in the text of this order.

By the Commission.

(S E A L)

Kenneth F. Plumb,
Secretary

Docket No. RI76-29 APPENDIX A

Shell Oil Company
Mobil Oil Company
The California Company, Division of Chevron Oil Company
Chevron Oil Company, Western Division
Amerada Hess Corporation
Phillips Petroleum Company
Tenneco Oil Company
Pennzoil Producing Company
Texaco, Inc.
Continental Oil Company
Atlantic Richfield Company
Jane Alida Baugh Beard, *et al.*
Michigan Wisconsin Pipe Line Company
United Gas Pipe Line Company
State of Louisiana
LaGloria Royalty Owners Association, Inc.
Enserch Corporation, Inc.
Natural Gas Pipeline Company of America
Gulf Oil Corporation
Tennessee Gas Pipeline Company
Austral Oil Company, Inc.
General American Oil Company of Texas
Ada Resources, Inc.
Crystal Oil Company
Inexco Oil Company
Estate of E. Cockrell, Jr., Deceased, *et al.*
Perry R. Bass, Inc.

Docket No. R176-29

APPENDIX B

William M. Fuller
Damson Oil Corporation
Cities Service Oil Company
Northern Natural Gas Company
Union Oil Company of California
Burmah Oil and Gas Company. Burmah Oil Development, Inc. and Signal Petroleum
Amoco Production Company
Getty Oil Company
Marathon Oil Company

APPENDIX B

DEPARTMENT OF ENERGY

FEDERAL ENERGY REGULATORY COMMISSION

NEWS RELEASE WASHINGTON, D. C. 20426

(S E A L) IMMEDIATE RELEASE
June 13, 1978 FE-316

FERC RELEASES SUMMARY OF INTRASTATE NATURAL PRICES FOR FIRST QUARTER 1978

The Federal Energy Regulatory Commission today released a staff report summarizing prices which natural gas producers subject to FERC regulation received for intrastate gas sales contracted for during the first quarter of 1978.

The average price for new contracts was $1.78 per thousand cubic feet in the first 1978 quarter, compared with $1.85 for the previous quarter. Prices ranged from 75 cents per thousand cubic feet in Oklahoma to $2.30 in Texas.

Prices for renegotiated or amended contracts in the first 1978 quarter averaged $2.03 per thousand cubic feet, compared with $1.79 for the previous quarter. Average prices ranged from 43 cents to $2.53, both in Texas.

The report covers independent natural gas producers with more than one billion cubic feet of annual jurisdictional sales. This is the tenth summary issued since the Commission's January 1975 order (No. 521) establishing a new form (No. 45) for collection of this data.

In view of the interest in recent natural gas sales at or above $1.75 per thousand cubic feet, this report includes percentages of volumes contracted at this price or

higher. These percentages are 59 percent for all new contract volumes, and 92 percent for renegotiated or amended contract volumes.

Form 45 reports were filed by 80 producers representing 414 intrastate contracts executed during the first quarter. The data excludes contracts having terms of less than one year, contracts for percentage sales and contracts not reporting volumes.

Individual Form 45 reports were found by the U.S. Court of Appeals for the Fifth Circuit to contain proprietary information which the Court said must not be made public. The report issued today therefore contains only aggregated data in compliance with the Court's decision.

The entire report, which includes summary tables by state and pricing area, accompanies this news release.

-FERC-

For further information
call, Stephen P. Siegel, 275-4006
(Area Code 202)

DC-E

FEDERAL ENERGY REGULATORY COMMISSION

INTRASTATE NATURAL GAS PRICES OF FERC JURISDICTIONAL NATURAL GAS COMPANIES SELLING MORE THAN ONE MILLION MCF PER YEAR IN INTERSTATE COMMERCE

SUMMARY BY STATE AND FERC GAS PRICING AREA, JANUARY, FEBRUARY, MARCH 1978

OFFICE OF PIPELINE AND PRODUCER REGULATION STAFF REPORT

Washington, D.C.

May, 1978

Louisiana

NEW CONTRACTS

¢/Mcf

	January	February	March	January-March
High	214.00	180.37	199.26	214.00
Average	194.38	180.37	198.62	194.90
Low	165.00	180.37	178.43	165.00
% Contract Volumes Sold Between				
201 - 250¢	16.5			14.0
151 - 200	83.5	100.0	100.0	86.0
101 - 150				
51 - 100				
0 - 50				
Contract Volumes Mcf	14,516,400	110,000	2,447,500	17,073,900

RENEGOTIATED OR AMENDED CONTRACTS

	January	February	March	January-March
High	218.63	212.85	182.35	218.63
Average	202.88	181.40	182.35	186.74
Low	127.45	155.36	182.35	127.45
% Contract Volumes Sold Between				
201 - 250¢	49.7	26.3		31.3
151 - 200	50.2	73.7	100.0	68.7
101 - 150	0.1			
51 - 100				
0 - 50				
Contract Volumes Mcf	2,761,580	8,035,550	372,311	11,169,441

FOR ARGUMENT

IN THE

Supreme Court of the United States

October Term, 1978

No. 77-648

Federal Energy Regulatory Commission,
Petitioner,

v.

Pennzoil Producing Company, et al.,
Respondents.

On Writ of Certiorari To the United States Court of Appeals For The Fifth Circuit

BRIEF OF RESPONDENT STATE OF LOUISIANA

Honorable Edwin W. Edwards
Governor, State of Louisiana

Honorable William J. Guste, Jr.
Attorney General, State of Louisiana

Honorable William C. Huls
Secretary, Department of Natural Resources, State of Louisiana

Honorable Ray T. Sutton
Commissioner of Conservation, State of Louisiana

James R. Patton, Jr.
David B. Robinson
Linda E. Buck
Timothy N. Seward
Patton, Boggs & Blow
1200 Seventeenth St., N.W.
Washington, D.C. 20036

Harry E. Barsh, Jr.
Camp, Carmouche, Palmer, Barsh & Hunter
1200 Seventeenth St., N.W.
Washington, D.C. 20036

Counsel for the State of Louisiana

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION,
Petitioner,

v.

PENNZOIL PRODUCING COMPANY, ET AL.,
Respondents.

On Writ of Certiorari To the United States Court of Appeals For The Fifth Circuit

---

BRIEF OF RESPONDENT STATE OF LOUISIANA

OPINIONS BELOW AND JURISDICTION

Louisiana adopts the references to the opinions below and the statement of jurisdiction set forth in the brief of the Federal Energy Regulatory Commission (Commission).

QUESTION PRESENTED

Whether the Commission has legal authority under the Natural Gas Act to consider the request of a natural gas company to recover in its rates a royalty cost which was computed as a percentage of the "market value"

of the gas which the natural gas company produced and sold.

STATUTES INVOLVED

The Commission's brief correctly cites the statutes involved.

STATEMENT

In the interest of brevity, Louisiana will not recount the procedural history of this proceeding, an undertaking which has been performed by other parties. The central issue in this case is simply one of jurisdiction—does the Federal Energy Regulatory Commission (FERC) have the legal authority to consider the request of a natural gas producer to recover the cost of "market value" royalty payments incurred under its lease.[1] Since that issue has, in fact, already been decided by this Court,[2] and because it has been fully briefed by other parties, Louisiana will not burden the Court with detailed argument on the jurisdictional issue. Rather, Louisiana, as a state which regulates the activities of natural gas producers within its borders, is making this submission primarily (1) to supplement the briefs of the other respondents and (2) to attempt to illuminate for the Court the nature of the lease relationship between a landowner and a producer and the reasons why that relationship is unaffected by the Natural Gas Act.

---

[1] The other issue in this case is whether the Commission should have considered the producers' abandonment application on its merits. Louisiana agrees with other Respondents (Shell Oil Company, Pennzoil Producing Company and United Gas Pipe Line Company) that the abandonment application should have been considered and adopts the arguments of those parties on the "abandonment" issue.

[2] Mobil Oil Corp. v. FPC, 417 U.S. 283 (1974).

SUMMARY OF ARGUMENT

A. A lease agreement between a producer and a landowner is a contractual arrangement governed by state law and is unaffected by the Natural Gas Act.

The royalty which the landowner bargains for is a cash payment given to him in exchange for the right to explore for natural gas, to extract it from the land, and to construct and operate production facilities. Unless the lease specifically gives the landowner the right to take a portion of his royalty in kind, and the landowner exercises that right, there is no gas "attributable to the royalty share." The formula by which the payment is computed is a matter to be determined by negotiation between the producer and the landowner.

The Commission has no jurisdiction to regulate landowners or royalty payments. *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F.2d 256 (D.C. Cir. 1972) *cert. denied*, 406 U.S. 976 (1972). The Commission's lack of jurisdiction flows from the carefully expressed intention of the Congress to leave with the states the responsibility for regulating all areas of natural gas production and distribution except for those matters which the states were barred from regulating by the Commerce Clause of the U.S. Constitution. *Federal Power Commission* v. *Panhandle Eastern Pipe Line Company*, 337 U.S. 507 (1947). The Commission, however, retains authority to protect consumers against unreasonable lease costs by denying recovery of costs which it finds to be imprudent.

B. A cost-based rate must permit natural gas companies to recover reasonably incurred costs. The Commission therefore has the authority and the responsibility to consider whether the costs incurred by the

producers in this case were prudent and reasonable. *Mobil Oil Corp.* v. *Federal Power Commission,* 417 U.S. 283 (1974).

ARGUMENT

A. A LEASE AGREEMENT BETWEEN A PRODUCER AND A LANDOWNER IS A CONTRACTURAL ARRANGEMENT GOVERNED BY STATE LAW AND IS UNAFFECTED BY THE NATURAL GAS ACT. IN DETERMINING WHETHER TO ALLOW PRODUCERS TO RECOVER THEIR ROYALTY COSTS, HOWEVER, FERC CAN REVIEW THOSE COSTS TO DETERMINE WHETHER THEY WERE REASONABLY INCURRED.

1. The Nature of the Relationship Between Landowner and Producer.

A landowner is not a producer or seller of natural gas. The Commission's persistent characterization of certain gas as "attributable to the royalty interest" (Commission Brief at, *e.g.*, 6, 7) is extremely misleading. The royalty paid to a landowner by a producer is a bargained-for cash consideration. The royalty payment is given to the landowner in exchange for the right he grants to the producer to explore for and produce natural gas from his property and for permitting the construction and operation of wells, pipes, and other facilities on his land. Typically, the producer owns all of the gas produced under the lease.[3]

The amount of the royalty is fixed contractually by the free bargain and exchange between the landowner and the producer, subject to whatever requirements

[3] Some leases allow the landowner to elect to take a portion of the gas in kind in lieu of receiving a cash payment. If that election were made, the landowner would then own his share of the gas, but if the election were not made, the landowner would own none of the gas.

might be imposed upon the relationship by state law. In the present case, the royalty was set at a fraction of the "market value" of the gas; it could just as easily have been set at a fixed dollar amount or according to some other formula.

2. The Effect of the Natural Gas Act on the Lease Relationship.

The royalty obligation is thus but one of a producer's many costs of production. As will be shown below, the Natural Gas Act gives the FERC no more control—direct or indirect—over lease costs than it has over the costs of labor or drilling equipment. Yet FERC suggests in its brief to this Court that the Commission need not even entertain the question of whether a royalty cost is reasonable because this Court might determine—in another case[4]—that the Natural Gas Act somehow preempts the state law of real property and compels the finding that a reference to "market value" must be construed as referring to the regulated rate. (FERC Brief at 27 n. 22). Similarly, Mobil Oil Company has even suggested that this Court defer decision in this case until it has decided whether to reconsider its decision to deny certiorari in *Lightcap*. Both FERC and Mobil, however, by suggesting that the Natural Gas Act could govern the interpretation of a mineral lease, ignore (1) the legislative history of the Natural Gas Act and (2) the clearly expressed intent of the Congress not to regulate lease transactions between producers and landowners. The meaning of disputed royalty provisions in oil and gas leases has always governed by state law, and Congress did not intend to disturb or

[4] Lightcap v. Mobil Oil Corp., 221 Kan. 448, 562 P.2d 1 (1977) *cert. denied,* Mobil Oil Corp. v. Lightcap, 434 U.S. 476, *Petition for Rehearing Pending,* Case No. 76-1694.

"preempt" the traditional role of the state courts in interpreting natural gas leases under state law.

As the Commission acknowledges in its brief to this Court (at 37 n. 22) and in the orders under review (A. 260), the Commission has no jurisdiction to regulate landowners or royalty payments. *Mobil Oil Corp.* v. *Federal Power Commission,* 463 F.2d 256 (D.C. Cir. 1972) *cert. denied,* 406 U.S. 976 (1972).

The D.C. Circuit, in *Mobil,* based its holding that the Commission lacked jurisdiction over royalty payments to landowners on the plain language of the Natural Gas Act. Section 1(b) of the Act limits the Commission's jurisdiction to:

> . . . [T]he transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption, for domestic, commercial, industrial, or any other use, and to natural gas companies engaged in such transportation or sale. . . . 15 U.S.C. § 717b.

The D.C. Circuit found that landowners, when they give natural gas companies a leasehold right to explore for and extract natural gas from their lands, are not engaged in the "sale in interstate commerce of natural gas for resale." The FPC had advanced to the Court various "policy" justifications for its attempt to assert jurisdiction over landowners. The Court rejected them, finding that the "policy" arguments were:

> not sufficient justification upon which to base an expansion of the Act to activities clearly not within its terms. Congress did not give the FPC carte blanche to take whatever action it might consider appropriate in furtherance of this purpose. The FPC is limited by the provision establishing its jurisdiction. 463 F.2d 256, 263.

The exclusion of landowners from the regulatory jurisdiction of the Commission was not accidental. It followed necessarily from the carefully defined Congressional plan to give the Commission only those limited powers necessary to enable it to exercise authority over those interstate transactions which this Court had previously held were beyond the powers of the states to regulate.[5] The purpose of the Act was to create federal regulation only where necessary to fill the "gap" where the states were powerless to act because of the commerce clause of the U.S. Constitution. The drafters of the Act deliberately sought to avoid extending federal regulation to those areas which the states constitutionally could regulate:

> . . . . [*T*]*he Natural Gas Act did not envisage federal regulation of the entire natural gas field to the limit of Constitutional power.* Rather, it contemplated the exercise of federal power as specified in the Act, particularly in that interstate segment which the states were powerless to regulate because of the Commerce Clause of the Federal Constitution. *The jurisdiction of the Federal Power Commission was to complement that of the state regulatory bodies.* Accordingly, Congress in § 1(b) of the Act not only prescribed the intended reach of the Commission's power, but also specified the areas into which this power was not to extend. *Federal Power Commission* v. *Panhandle Eastern Pipe Line Co.,* 337 U.S. 498, 502-3 (1949) (footnote omitted, emphasis supplied).

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[5] See the discussion of the Court in Panhandle Eastern Pipe Line Co. v. Public Service Commission, 332 U.S. 507 (1947) at 514-19.

And:

> The Act, though extending federal regulation, had no purpose or effect to cut down state power. On the contrary, perhaps its primary purpose was to aid in making state regulation effective, by adding the weight of federal regulation to supplement it and reenforce it in the gap created by the prior decisions. *The Act was drawn with meticulous regard for the continued exercise of state power, not to handicap it or dilute it in any way. Panhandle Eastern Pipe Line Co.* v. *Public Service Commission,* 332 U.S. 507, 517-518 (1947) (footnotes omitted, emphasis supplied).

This Court has emphasized that those areas which the states were constitutionally capable of regulating before the Natural Gas Act was passed were left to be governed by the states and were not touched by the Natural Gas Act:

> The legislative history of the Act is replete with evidence of the care taken by Congress to keep the power over the production and gathering of gas within the states. . . . The Natural Gas Act was designed to supplement state power and to produce harmonious and comprehensive regulation of the industry. *Neither state nor federal regulatory body was to encroach upon the jurisdiction of the other. Federal Power Commission* v. *Panhandle Eastern Pipe Line Company, supra,* 337 U.S. 507, 509-13 (footnotes omitted, emphasis supplied).

Since the Natural Gas Act purposefully preserved to the states the rights which they could exercise when the Act was passed, the traditional role of the states in regulating the relationship between landowners and producers was left undisturbed. The drafters of the Natural Gas Act certainly could have had no intent to "preempt" state law on the interpretation of royalty agreements. The interpretation of a royalty clause re-

mains a matter of state law to be decided by the state courts.

3. Commission Review of Royalty Costs.

The fact that the Commission has no regulatory jurisdiction over landowners or royalty payments does not, by any means, mean that the Commission is powerless to protect the consumer against lease costs which have been imprudently entered into. The Commission's control over lease costs is indirect. In that respect, it is no different from its control over other costs of production. Just as the FERC can deny the recovery of the cost of "platinum pipe" (FERC Brief at 18), it can deny recovery of a royalty cost which it finds to be imprudent. The rule was well stated by the D.C. Circuit in *Mobil:*

> . . . [T]he FPC's jurisdiction over rates chargeable by a producer includes authority to determine the reasonableness of costs incurred, even though these are not subject to direct FPC control, and that establishes authority to review royalty payments, or drilling rig rentals, or any other element of the producer's cost of service. 463 F.2d 256, 263 (footnote omitted).

B. THE COMMISSION HAS AUTHORITY TO PERMIT PRODUCERS TO RECOVER THE COSTS OF PRUDENTLY INCURRED ROYALTY OBLIGATIONS.

As explained more fully in the briefs of Shell Oil Company, Pennzoil Producing Company and United Gas Pipe Line Company, cost-based rates must of course be constructed so as to permit gas companies to recover reasonably incurred costs. The D.C. Circuit has stated the principle this way:

> Expenses. . . . are facts. They are to be ascertained, not created, by the regulatory authorities. *If prop-*

> *erly incurred, they must be allowed,* as part of the composition of the rates. Otherwise, the so-called allowance of a return upon the investment being an amount over and above expenses, would be a farce. *Mississippi River Fuel Corp.* v. *Federal Power Commission,* 163 F.2d 433, 437 (D.C. Cir. 1947) (emphasis supplied).

The proper inquiry is thus not what a cost is "based on" but, rather, whether the cost incurred was prudent and reasonable when incurred. Just four years ago, in *Mobil Oil Corp.* v. *Federal Power Commission,* 417 U.S. 283 (1974), this Court confirmed as clearly as possible the obvious proposition that the Commission has authority to allow producers to recover the costs of royalties like those at issue in this case. The Commission has unaccountably chosen to ignore this Court's instructions to it.

In *Mobil,* the Fifth Circuit below had sustained the Commission's determination that area rates should not be adjusted simply because royalty costs might rise in the future.[6] In so holding, however, the Fifth Circuit took as a given the proposition that any significantly increased royalty costs which were actually incurred by the producer could be a proper component of the rate structure:

> Of course the royalty obligations of the producers are cost components of the rate structure. *Any alteration of this component would necessarily alter the departure point of the rate calculations.* 483 F.2d 880, 911 (emphasis supplied).

Following logically from that principle, the Fifth Circuit found two corollary propositions: (a) that producers who actually incurred increased royalty obligations could petition the Commission for individualized relief, and (b) that if conditions changed on an industry-wide basis in the future, changes in the ceiling rates themselves could be appropriate:

> If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may *certainly* petition FPC for individualized relief. Permian contemplated it. FPC has on occasion given it . . . and we find it to be far preferable to the speculative prophecy of future royalty components. If the royalty obligations are such as to make the rates established by Op. 598, and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will *certainly* have recourse to the administrative process. And . . . if FPC determines that future events substantially change the rate structure for the industry as a whole, it may make appropriate changes. 483 F.2d 880, 911 (emphasis supplied).

Affirming, the Court quoted with approval the relevant portions of the Court of Appeals decision and stated that "in any event an affected producer is entitled to seek individualized relief." 417 U.S. 283, 328.

Yet the Commission now seeks to claim that it lacks jurisdiction even to consider the relief which this Court told the producers they were "entitled to seek." The Commission's argument is absurd.

The Commission has attempted to find support for its position in a strained interpretation of this Court's decision in *FPC* v. *Texaco,* 417 U.S. 380 (1974). But *Texaco* dealt with a very different issue. *Texaco* held only that *prices* received by producers for natural gas may not be determined solely by the price the gas would bring in a free market. It decidedly did not hold

[6] The decision below was reported as Placid Oil Co. v. Federal Power Commission, 483 F.2d 880 (Fifth Cir. 1973).

or even imply that a producer may not recover reasonably incurred *costs* which are, by contract prudently entered into, fixed at a percentage of the market price.

CONCLUSION

The decision of the Court of Appeals below is correct under this Court's prior decision in *Mobil* and under well-established rate making principles. The decision of the Court of Appeals should be affirmed.

Respectfully submitted,

JAMES R. PATTON, JR.
DAVID B. ROBINSON
LINDA E. BUCK
TIMOTHY N. SEWARD
PATTON, BOGGS & BLOW
1200 Seventeenth St., N.W.
Washington, D.C. 20036

HARRY E. BARSH, JR.
CAMP, CARMOUCHE, PALMER, BARSH & HUNTER
1200 Seventeenth St., N.W.
Washington, D.C. 20036

Counsel for the State of Louisiana

HONORABLE EDWIN W. EDWARDS
Governor, State of Louisiana

HONORABLE WILLIAM J. GUSTE, JR.
Attorney General, State of Louisiana

HONORABLE WILLIAM C. HULS
Secretary, Department of Natural Resources, State of Louisiana

HONORABLE RAY T. SUTTON
Commissioner of Conservation, State of Louisiana

October 19, 1978

No. 77-648

In the Supreme Court of the United States

OCTOBER TERM, 1978

FEDERAL ENERGY REGULATORY COMMISSION,
Petitioner,

v.

PENNZOIL PRODUCING COMPANY, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

MEMORANDUM FOR RESPONDENT MOBIL OIL CORPORATION

TOM P. HAMILL
Mobil Oil Corporation
Nine Greenway Plaza
Suite 2700
Houston, Texas 77046

CARROLL L. GILLIAM
PHILIP R. EHRENKRANZ
1730 M Street, N.W.
Washington, D.C. 20036

Attorneys for Respondent Mobil Oil Corporation

Of Counsel:

GROVE, JASKIEWICZ,
GILLIAM AND COBERT
1730 M Street, N.W.
Washington, D.C. 20036

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MEMORANDUM FOR RESPONDENT MOBIL OIL CORPORATION

Mobil Oil Corporation (Mobil), a respondent in this case, submits this memorandum in response to the brief filed on behalf of the petitioner Federal Energy Regulatory Commission (the Commission):

1. This case should be held in abeyance pending review and decision by this Court in *Mobil Oil Corporation* v. *Harry Lightcap, et al.*, No. 76-1694.

2. In No. 76-1694, Mobil seeks review of the decision of the Supreme Court of Kansas in *Harry Lightcap* v. *Mobil Oil Corporation*, 221 Kan. 448, 562 P.2d 1 (1977).

The major question presented is whether a state court is barred, as a matter of law, from determining royalty payments for regulated sales of natural gas on the basis of unregulated "market values." When that case is reached on the merits, Mobil will show that the Natural Gas Act pre-empts the relevant "market" for determining the amount of royalty for sales regulated under the Act, and that the Supremacy and Commerce clauses of the United States Constitution preclude entry by a court of a judgment in collateral litigation based on "values" derived from the unregulated intrastate market. The result of such conclusions will be that for a regulated sale, the royalty payment is limited by the rates prescribed by the Commission in the exercise of its jurisdiction under the Natural Gas Act.

3. In No. 76-1694, the petition for writ of certiorari was denied, but Mobil's petition for rehearing is pending. That petition is supported by a memorandum filed by the Solicitor General on behalf of the Commission urging that the petition be granted and the Court hear the case and concurring with Mobil's position on the merits. The Court requested a response to the petition for rehearing which has been filed by counsel for Harry Lightcap, et al., and the petition for rehearing is now ripe for disposition by the Court.

4. A decision by this Court in No. 76-1694 consistent with the positions of Mobil and the Commission in that case will render the questions presented in this case moot. In this case, the questions are whether the Natural Gas Act permits or requires the Commission to allow a regulated producer to pass on to pipeline customers increases in royalty payments based on unregulated intrastate "market value" determined in collateral litigation between the producer and royalty owners, or, alternatively, whether "abandonment" under Section 7(b) of the Act must be allowed as to the royalty interest gas

under such circumstances. If in No. 76-1694, it is concluded that the Natural Gas Act operates to pre-empt the "market" for regulated sales, royalty payments will be based on rates no higher than those prescribed by the Commission for producers' sales; there will be no increases based on higher "market values" determined in collateral litigation to be passed on to pipelines, their customers, and interstate consumers; and there will be no occasion for the Commission to reach questions such as those raised in this case. The relevant "market" for regulated sales will be determined and controlled by Commission-prescribed ceilings, and the issues presented here will be moot.

5. This Court's consideration of and decision in No. 76-1694 thus should precede the Court's consideration of the questions presented in this case.

For the foregoing reasons, Mobil urges the Court to hold this case in abeyance until after decision by the Court on the merits in *Mobil Oil Corporation* v. *Harry Lightcap, et al.*, No. 76-1694.

Respectfully submitted,

TOM P. HAMILL
Mobil Oil Corporation
Nine Greenway Plaza
Suite 2700
Houston, Texas 77046

CARROLL L. GILLIAM
PHILIP R. EHRENKRANZ
1730 M Street, N.W.
Washington, D.C. 20036

Attorneys for Respondent Mobil Oil Corporation

Of Counsel:

GROVE, JASKIEWICZ, GILLIAM AND COBERT
1730 M Street, N.W.
Washington, D.C. 20036

September 29, 1978

FOR ARGUMENT

No. 77-648

In the Supreme Court of the United States

OCTOBER TERM, 1978

FEDERAL ENERGY REGULATORY COMMISSION,
PETITIONER

v.

PENNZOIL PRODUCING COMPANY, ET AL.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS FOR
THE FIFTH CIRCUIT

REPLY BRIEF FOR THE
FEDERAL ENERGY REGULATORY COMMISSION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530

ROBERT R. NORDHAUS
General Counsel
Federal Energy Regulatory Commission
Washington, D.C. 20426

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In the Supreme Court of the United States

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REPLY BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION

I.

Before addressing those contentions of the respondents that warrant a brief reply (pages 7-16, *infra*), we wish to advise the Court of a recent legislative development relevant to this case. As noted in our principal brief (p. 17 n. 9), the 95th Congress was considering the Natural Gas Policy Act of 1978 ("NGPA"), H.R. 5289, 95th Cong., 2d Sess. (1978). On September 27, 1978, the bill as reported by the conference committee (see S. Rep. No. 95-1126, 95th Cong., 2d Sess., to accompany H.R. 5289) was approved by the Senate (124 Cong. Rec. S16265 (daily ed.)), and on October 14, 1978, the same bill and the same conference report (as H.R. Rep. No. 95-1752, 95th Cong., 2d Sess.) were approved by the House (124 Cong. Rec. H13427 (daily ed.)). The bill was signed into law by the

President on November 9, 1978; Pub. L. No. 95-621, 92 Stat. 3350.[1]

We shall discuss the new Act as it appears to bear on the issues in this case.

The court of appeals set aside orders of the Commission refusing to authorize two producers, Pennzoil Producing Company and Shell Oil Company, to pass through to their interstate pipeline customer, the United Gas Pipe Line Company—and hence to United's customers—incremental royalty costs to be incurred in a proposed settlement by Shell and Pennzoil of their lessor's claims under "market value" royalty clauses in the producers' leases. The court also set aside the Commission's rejection of an alternative settlement proposal whereby the producers would have abandoned delivering to United, and paid in kind to their lessor instead, the portion of the gas attributable to the royalties claimed by the lessor. The Commission found that the incremental royalty costs proposed in the settlement were based on the unregulated intrastate market price for natural gas, and held that it was not authorized to allow the pass-through of such costs as just and reasonable rates under the Natural Gas Act. The Commission also held that since the supply of gas in the leaseholds had not been depleted, and interstate service would have to continue even if the properties reverted to the lessor, no basis for abandonment under Section 7(b) of the Natural Gas Act had been shown.

A. The first question in this case is whether the Natural Gas Act authorizes the Commission to include in its rates for the interstate sale of natural gas, and thus to pass on to interstate consumers, royalty costs based on the

[1]Copies of the Act and of the Conference Report have recently been lodged with the Clerk of the Court in connection with Nos. 77-1652 and 77-1654.

unregulated price of natural gas in the intrastate market. Under the Natural Gas Policy Act, all wellhead sales of natural gas after December 1, 1978, will be subject to price ceilings specified in the Act. Thus, there will no longer be an unregulated intrastate market. However, there will still be considerable differences between the allowable prices for intrastate sales and for interstate sales of the kind involved here. Moreover, insofar as this case involves sales of gas made by the respondent producers before December 1, 1978, the validity of the Commission's decision will govern the rights and liabilities of the parties with respect to those sales.

The issue presented here remains significant with respect to sales of natural gas made after December 1, 1978. For such sales, Title I of the NGPA establishes a series of specific maximum price levels to be applied to particular categories of gas (Sections 101(b)(4), 102-109). These ceilings encompass sales made in both interstate and intrastate commerce. One of the categories is gas previously dedicated to interstate commerce under the Natural Gas Act (Sections 2(18), 104, 106(a))—such as the gas involved in this case. Under Section 104(b), the ceiling price for this gas will be the higher of (a) the just and reasonable rate established by the Commission as of April 20, 1977, augmented thereafter by a monthly inflation factor, or (b) any just and reasonable rate established by the Commission between April 20, 1977, and November 8, 1978, which is applicable to the particular gas involved. Section 104(b)(2) provides, however, that the Commission by rule or order may prescribe a ceiling price higher than the ceiling which would otherwise be applicable under Section 104(b), if it finds that the higher ceiling would be just and reasonable within the meaning of the Natural Gas Act.[2]

[2]Under Section 601(b) of the NGPA, amounts paid by natural gas companies in purchasing natural gas after December 1, 1978, will be

Section 106(a) prescribes the ceiling price for "interstate rollover contracts" executed after November ~~9~~ 8, 1978—that is, contracts replacing earlier contracts for the sale of gas that was dedicated to interstate commerce before enactment of the NGPA (see Sections 2(12), 106(a)). The ceiling prescribed by Section 106(a) is 54 cents per million Btu's, adjusted for inflation, unless the Commission-established rate previously applicable to the expiring contract is higher, in which case the ceiling is the rate applicable to the expiring contract, augmented by a monthly inflation factor. Under Section 106(c), however, the Commission may prescribe a higher ceiling price than otherwise would be applicable under Section 106(a), if it finds that the higher ceiling is just and reasonable within the meaning of the Natural Gas Act.

Thus, under Sections 104 and 106(a) of the NGPA, the rates previously established by the Commission under the just and reasonable standard of the Natural Gas Act continue to affect sales of gas previously dedicated to interstate commerce—such as the gas involved in this case—and the Commission continues to have authority to prescribe a higher ceiling price for such gas under the same standard.

At the time of the administrative hearing, the gas involved in this case was subject to rates established under the FPC's Opinions Nos. 598 (*Southern Louisiana Area Rate*) and 699 (*First National Natural Gas Rate*). The gas covered by the Southern Louisiana rate had a ceiling price of 31.11 cents per Mcf, including all adjustments; the gas covered by the National Rate had a ceiling of 59.88 cents per Mcf, including all adjustments (A. 42, 66-67). These

deemed "just and reasonable" for the purposes of the rate-setting provisions of the Natural Gas Act if they do not exceed the applicable ceiling established by the NGPA. And under Section 601(c), amounts meeting that test may be passed through by natural gas companies to their customers.

amounts, as adjusted by subsequent Commission orders,[3] will constitute the base price to which the monthly inflation factor will be applied under Sections 104 and 106(a) of the NGPA to determine the ceiling price after December 1, 1978, for gas from these leaseholds flowing under existing contracts, and subsequently under any rollover contracts.

The incremental royalty that Pennzoil and Shell seek the Commission's approval to pass through here would, of course, raise their rates (by the amount of the increment) above these applicable ceilings. The question whether the Commission may approve the pass-through of such incremental royalty costs as "just and reasonable" under the standard of the Natural Gas Act—that is, the question presented in this case—thus persists under the new Act, although its practical significance for the future may be decreased as the differential between interstate and intrastate prices is decreased.

Moreover, if the court of appeals is correct in holding that incremental royalty costs based on the previously unregulated market price may constitute just and reasonable prices passed through to pipelines under the Natural Gas Act, then the base price under Sections 104 and 106(a) of the NGPA will be substantially inflated. Thus, with respect to gas dedicated to interstate commerce and hence subject to Sections 104 and 106(a) of NGPA, the question whether incremental royalty costs arising from "market value" leases referring to the unregulated market may be passed through to producers—that is, held "just and reasonable" under the standard of the Natural Gas Act—will remain significant under the new Act.

[3]The gas covered by Opinion No. 598 is now subject to the rates prescribed in Opinion No. 749 (18 C.F.R. 2.56b(a)(1)). The gas covered by Opinion No. 699 is now subject to the rates prescribed in Opinion No. 770 (18 C.F.R. 2.56a(a)(3)).

B. The second question in this case is whether the Commission properly denied a request to permit lessee producers of natural gas to abandon volumes of gas dedicated to interstate service so that those volumes could be paid as royalties in kind to landowner lessors for sale on the intrastate market.

The NGPA expressly codifies the concept established by decisions under the Natural Gas Act that reserves from which gas is sold in interstate commerce for resale are "committed or dedicated" to interstate commerce.[4] Under Sections 2(18) and 601(a) of NGPA, future sales of gas that was so dedicated on November 8, 1978, remain within the Commission's jurisdiction under Section 1(b) of the Natural Gas Act (subject, however, to NGPA's rate ceiling provisions, and with certain categories of gas excepted). Future sales of gas from reserves so dedicated will therefore remain subject to the conditions of certificates previously issued under Section 7(e), and to the requirement that the service of supplying gas from such reserves may not be abandoned without the Commission's approval. These provisions assure that pipelines presently relying on supplies of dedicated gas may continue to do so. Even though, after December 1, 1978, all producer sales of natural gas, whether interstate or intrastate, will be subject to ceiling prices under NGPA (Section 101(b)(4)), there are significant differences between the ceilings for dedicated gas set by Sections 104 and 106(a) and the ceilings for gas that is not dedicated and hence is not subject to the abandonment requirement of the Natural Gas Act.[5] Thus, if the royalty gas claimed

[4]See, *e.g.*, *California v. Southland Royalty Co.*, No. 76-1114 (May 31, 1978); *Sunray Mid-Continent Oil Co. v. FPC*, 364 U.S. 137 (1960).

[5]For example, under Section 104, the maximum unadjusted December 1978 delivery price for dedicated "flowing gas" (*i.e.*, gas produced from a well on which drilling commenced prior to January

by the lessors under the "market value" clauses should have been abandoned to them prior to NGPA, as respondents contend, there may be substantial price consequences, even if the lessor sells the gas to the same interstate pipeline to which it was delivered under the prior dedication. The abandonment issue therefore remains significant notwithstanding the enactment of the NGPA.

II.

A. Respondents present the decision of the court of appeals as one that would not require the Commission to allow the pass-through of the royalty costs in question, but would only require the Commission to consider whether to do so. As Pennzoil states (Br. at 10 n. 16): "All the decision stands for is the proposition that the Commission has authority to grant relief if a review on the merits demonstrates that such relief would meet the statutory tests." Pennzoil argues that "the Commission has authority to review royalty costs and permit their recovery in rates if found on the merits to be just and reasonable" (*id.* at 13-14), and that "the Commission must at least consider on the merits whether the public interest requires that producers be allowed to recover market value royalty costs * * *" (*id.* at 22-23). See also *id.* at 9 n. 15, 10, 11, 15 n. 20. Pennzoil appears to ask only for "a full inquiry into whether such costs were prudently incurred" (*id.* at 20). Shell presents the case in the same minimal and procedural light:

> In remanding the case to the Commission for rehearing on the merits, the Court of Appeals did not require the Commission to find for the producer. The Commission was merely required to consider the

1973 (43 Fed. Reg. 53270, 53342) is $0.332 per million Btu. 43 Fed. Reg. 53334. In contrast, under Section 109, the maximum unadjusted delivery price for the same month for undedicated natural gas not governed by other provisions (*e.g.*, Sections 102, 103, 108, 109) is $1.630 per million Btu. *Ibid.*

> merits of the producers' position, after giving them an opportunity, on a reopened record, to attempt to prove their case.

Shell Br. at 9; see also *Id.* at 12, 15, 19, 31.

But respondents also seek to have it the other way, and in so doing they betray a more accurate recognition of what this case is about. Pennzoil and Shell both take the position that, at least in the case of the rate relief *they* seek on the basis of their proposed state court settlement with their lessor, the Commission would indeed be required to grant the relief. Pennzoil says (Br. at 23): "on that question there can be no dispute," since "[t]he price increase would generate absolutely no profit because it does nothing more than recover increased costs, and no one has claimed the costs to be recovered were other than prudently incurred." And Shell argues (Br. at 20-21) that since the leases were entered into before the Natural Gas Act or before the *Phillips* decision, and since the royalty percentages "conformed with the industry practice in the area at the time, and were necessary in order to purchase the leases"—"[o]n these facts, it is apparent that any holding by the Commission that the royalty provisions of these leases were 'excessive or unreasonable' would be arbitrary and capricious."

These claims by respondents document our contention that the decision of the court of appeals "seems thus to establish a presumption that such relief must be granted unless exceptional circumstances are present" (Commission opening br. at 13; see also *id.* at 22-25).[6] Respondents assert that even though their proposed "market value" royalty increments are based not on a state court judgment or precedent but only on a proposed settlement, the Commission would be required to find them "just and

[6]Compare Pennzoil Br. at 10 n. 16, calling this contention "absurd."

reasonable" and to let them be passed through to pipelines and interstate consumers. Respondents' arguments would apply generally—that is, in the absence of exceptional circumstances—to any royalty costs based on "market value" leases that were held, or that might be held, to refer to the intrastate market. It will typically be the case that such leases were entered into before the Natural Gas Act or before the *Phillips* decision, and that the royalty percentages in the leases conformed with industry practice in the area at the time and hence were necessary in order to purchase the leases.[7] It will always be the case that the requested pass-through relief "would generate absolutely no profit" because it would simply pass through the increased royalty costs.

Given these generic characteristics of claims for "market value" royalties based on the intrastate market, it is illusory to suggest that the decision of the court of appeals would only require the Commission "to hear and review individual requests for rate relief and to determine whether, on the merits, they should be granted" (Pennzoil Br. at 10). Exceptional cases aside, those "individualized" proceedings (*id.* at 17; Shell Br. at 9) would offer nothing individual for the Commission to consider. The facts that are present here—and that respondents contend compel the Commission to grant relief—would be present on a state-wide basis in any state whose courts had held, or might hold, that "market value" royalty clauses refer to the intrastate market. Unless the Commission may exclude such royalty costs from its interstate rates on a

[7]The court of appeals also suggested that these facts would compel the granting of relief: "Determination of the reasonableness of a cost necessarily requires consideration of market price. In all probability, the reasonableness of a great many costs of gas production must be determined by the prevailing market price in an uncontrolled market. The Commission has failed to suggest why royalty costs in an uncontrolled market are any different from any other cost." Pet. App. 7a.

generic basis, on the ground that their inclusion would be improper under the Act,[8] it will be required to include them on a generic basis, and thereby undermine the regulatory scheme. There is no middle ground.

B. The choice made by the Commission was compelled by this Court's decision in *FPC* v. *Texaco, Inc.*, 417 U.S. 380, 394-399 (1974). See our opening brief at 19-21.[9] Respondents contend that the Commission misconstrued that decision (Pennzoil Br. at 15-20; Shell Br. at 13-17). They emphasize particular words from the Court's statements that "the prevailing price in the marketplace cannot be *the final measure* of 'just and reasonable' rates mandated by the Act," that "Congress could not have assumed that 'just and reasonable' rates could *conclusively* be determined by reference to market price," and that "the Commission lacks the authority to place *exclusive* reliance on market prices" (417 U.S. at 397, 399, 400, emphasis added; see Shell Br. at 15). They similarly stress the underlined phrase in the Court's passage:

> This does not mean that the market price of gas would never, in an individual case, coincide with just and reasonable rates or not be a relevant consideration in the setting of area rates, see Permian Basin Area Rate Cases, 390 U.S. at 793-795; *it may certainly be taken into account along with other factors*, Southern Louisiana Area Rate Cases, 428 F. 2d 407, 441 (C.A. 5), cert. denied *sub nom.* Associated Gas Distributors v. Austral Oil Co., 400 U.S. 950 (1970). It does require, however, the conclusion that Congress rejected the identity between the "true" and the "actual" market price.

[8]Pennzoil agrees with us that the decision of the court of appeals precludes the Commission from taking such a position. Pennzoil Br. at 10.

[9]For example, the Court in *Texaco* found unacceptable "the implication * * * that reasonableness would be judged by the standard of the marketplace." *Id.* at 396.

417 U.S. at 399, emphasis added (case name italics omitted); see Shell Br. at 16. Respondents thus contend that royalties based on the price of gas in the unregulated market can be included by the Commission in its determination of reasonable rates—indeed, *must* be included if they were "prudently incurred"[10]—so long as they are not the "exclusive" or "entire" component (Shell Br. at 16-17).

Besides ignoring the thrust of the Court's decision and opinion in *Texaco*, respondents misapprehend the Commission's decision here. Respondents' characterization to the contrary (see Shell Br. at 16-17) notwithstanding, the Commission determined that the incremental royalty embodied in the proposed settlement of the state court suit for royalties based on the unregulated market was indeed based on nothing other than the price in the unregulated market. The Commission found that it was being called on to authorize, as in *Texaco* (see 417 U.S. at 384-385), an automatic "tracking increase" based on the market price for intrastate sales in the same producing area (A. 181-182, 261). Of course, the proposed settlement between Pennzoil, Shell, and their lessor—since it was a settlement—did not pass through the full amount of the "market value" royalties claimed by the lessor. But the Commission found that "the impetus of the settlement is the market value of the royalties and no consideration has been given to regulated rates" (A. 261). Again on rehearing, the Commission found it "plain that the royalty is to be based on 78 cents, which is the settlement's reflection of market prices, that are above the area ceiling

[10]*E.g.*, *Pennzoil* Br. at 20, 23; Shell Br. at 12, 20-21; see pages 7-10, *supra*.

prices" (A. 292). Thus, the Commission's ruling rests on its characterization of the record. The Commission found that it was being asked to approve as "just and reasonable," and to pass through to consumers, incremental royalty costs springing exclusively from the unregulated price for natural gas—the very defect the Court found in the Commission's order in *Texaco* (417 U.S. at 399).[11]

C. Shell contends (Br. at 20-24; A. 285-286) that the Commission's refusal to grant the relief it requested denies it due process and may be confiscatory. Neither Shell nor Pennzoil, however, laid an adequate foundation in the hearing before the administrative law judge for any claim of confiscation. Pennzoil made no showing of either its

[11]The Commission's finding was not only reasonable but inescapable. Respondents have not suggested any motive for the settlement other than the desire to eliminate the claim being settled. And if it would be improper for the Commission to pass through to consumers the full payment of such claims, settlements must be treated likewise, else the vice is simply discounted. As the Court held in *Texaco*, "the Act makes unlawful all rates which are not just and reasonable, and does not say a little unlawfulness is permitted." 417 U.S. at 399.

Disregarding the impetus for the settlement, Shell and Pennzoil contend that its *computation* was based on factors other than the unregulated market price, including the Commission's ceiling rates (Shell Br. at 10-11; Pennzoil Br. at 6-8). It is hard to see why this would make a difference—suppose the settlement was computed as ten times the regulated rate—but in any event the record does not support the claim. The record shows only the settlement formula, under which the royalty was to be based on the higher of 78 cents per Mcf (with adjustments) or 150% of the highest Commission-set area national rate (A. 17-18). The record provides no support for Pennzoil's claim (Br. at 7) that the 78-cent figure was calculated as 150% of the Commission's then-existing national rate, so that in either form "the incremental royalty is tied directly to Commission set rates and not at all to intrastate rates" (*ibid.*; footnote omitted). If this were true, it would be at odds with the settlement's alternative provision for abandonment of the "royalty gas" (A. 20-21), which is plainly designed to allow sale of that gas in the intrastate market.

overall or its out-of-pocket costs for operating the properties involved (A. 175-176). Shell offered some evidence concerning its costs and revenues, but none concerning its capital costs, and none with respect to revenues from condensates produced from the wells involved (A. 175-180). Moreover, Shell's claims of operation at a loss were computed on the basis of the unadjudicated $1.40 per Mcf "market value" figure claimed by the lessor, not the 78 cents per Mcf figure agreed to by the lessor in the proposed settlement that was before the Commission (A. 180). The administrative law judge found that on the basis of that settlement, without reference to capital costs or condensate revenues, Shell would earn a profit from gas operations under the 1934 and 1952 leases of $178,951 in 1975 (A. 178-179).[12]

Because Shell and Pennzoil failed to make a case for confiscation, there is no occasion on this record to determine whether the Commission's adherence to this Court's holding in *Texaco* would ever present a confiscation issue. The Commission's decision here does not preclude—under the Constitution and the Act it could not preclude—consideration of the issue if it should be adequately presented. See *California* v. *Southland Roy-*

[12]Shell says (Br. at 21-22) it was improper for the administrative law judge to use the 78 cent settlement figure instead of the $1.40 figure claimed in the litigation,because "[i]f the Commission denies the relief requested, there is no settlement * * *" (*id.* at 21). Thus, having presented the settlement to the Commission for a ruling, Shell complains that the Commission ruled on it. As the administrative law judge pointed out (A. 180), if the settlement is terminated because of the Commission's refusal to grant the relief sought, that will be the choice of Shell or Pennzoil, not of the lessor (and not of the Commission).

alty Co., No. 76-1114 (May 31, 1978), op. slip. 8; *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283, 328 (1974).[13] It was not adequately presented here.[14]

D. Respondents concede that this Court's decision in *California* v. *Southland Royalty Co.*, No. 76-1114 (May 13, 1978), wipes out the court of appeals' ground for setting aside the Commission's refusal to permit them to abandon delivery of the royalty portion of the gas and pay it in kind to the lessor. They contend, however, that the public convenience and necessity required abandonment, even though the gas supply was not depleted,

[13]The Commission noted the speculative and premature nature of the "bind" in which Shell and Pennzoil claimed to find themselves:

> The real issue in this proceeding is whether the * * * Commission can legally grant any form of rate relief above either an area or nationwide just and reasonable rate solely because the producer selling the gas in interstate commerce *may* be obligated to make a royalty payment based not upon the regulated price the producer receives for the gas, but rather on the "market value" of the gas. Moreover, as in this proceeding, the question becomes somewhat speculative because of litigation between producer lessees and lessors over the extent of such royalty obligations. [Pet. App. 21a; emphasis in original.]

[14]Pennzoil cites (Br. at 20-25) two Commission decisions as supporting the pass-through of royalty costs based on the unregulated market. Those decisions are inapplicable here. In *El Paso Natural Gas Co.*, Docket No. RP72-150 (Feb. 16, 1977), the Commission noted that "unlike in *Pennzoil*, this case does not involve a request for special relief above applicable Commission determined and Court approved just and reasonable ceiling rates" (slip op. 15). The case involved special circumstances concerning a pipeline; the Commission's rate-setting scheme for pipeline-owned production allows an individual cost-of-service approach in special circumstances. See 18 C.F.R. 2.66. In *Columbia Gas Transmission Corp.*, Docket No. RP73-65 (Aug. 1, 1977), the Commission held that a pipeline's purchased gas costs for non-jurisdictional gas should not be excluded from its base so long as they were reasonable and prudent. The present case involves jurisdictional gas.

because if the lessor prevails in state court, respondents might lose the leases or be required to cease drilling additional wells. Shell Br. at 26-31; Pennzoil Br. at 25-28. In addition, they contend that if the property reverts to the lessor, the lessor might qualify as a small producer entitled to charge higher rates than those presently applicable. See 18 C.F.R. 157.40; Shell Br. at 30; Pennzoil Br. at 27. Respondents contend that the Commission did not deal explicitly with these arguments and that the case should now be remanded for it to do so (Shell Br. at 27, 31; Pennzoil Br. at 27-28).

The Commission's rejection of the abandonment proposal was, however, inclusive. It found "no reason to grant abandonment on the basis of this record," and further that "the public convenience and necessity, present or future, is not served by granting an abandonment authorization that would likely result in the subject gas being diverted from the interstate market to the intrastate market" (Pet. App. 24a). In any event, respondents did not raise on rehearing the arguments they now say the Commission should consider. Pennzoil contended only that the substitution of the lessor for itself and Shell would substitute an inexperienced royalty owner for experienced producers (A. 280). Shell argued only that the Commission should have permitted one of the alternatives provided in the proposed settlement, and that it erred in failing to consider that rejection of both might result in victory for the lessor in the lawsuit and hence in loss of the gas supply to the pipeline (A. 283-284). Thus, the arguments now put forward were not preserved on rehearing as required by Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

United Gas Pipe Line Company did argue on rehearing that even if the gas remained in interstate commerce, the lessor might qualify for the small producer rates, thus increasing the price for the gas (A. 287-288). United, however, does not make this argument in its brief in this

Court (see United Br. at 20-23).[15] In any event, none of the parties before the Commission presented any evidence in this record indicating that the possibility of an increase in rates from national to small producer levels warranted abandonment of service under the existing contracts.

CONCLUSION

For the reasons stated in the Commission's principal brief and in this reply brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

WADE H. MCCREE, JR.
Solicitor General

ROBERT R. NORDHAUS
General Counsel
Federal Energy Regulatory Commission

NOVEMBER 1978

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[15]The contention is unsupported in any event. The administrative law judge found that the lessor, Williams, could not qualify for the small producer rate, since sales from these leases exceed 10 million Mcf a year (A. 184; see 18 C.F.R. 157.40(b)).

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION,
PETITIONER

versus

PENNZOIL PRODUCING COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF FOR THE AMICI CURIAE,
WILLIAMS, INC., ET AL.

CAMPBELL C. HUTCHINSON
ANTHONY M. DiLEO
Stone, Pigman, Walther,
Wittmann & Hutchinson
1000 Whitney Bank Building
New Orleans, Louisiana 70130
Attorneys for Amici Curiae

SCOFIELDS' QUALITY PRINTERS, P. O. BOX 53096, N. O., LA. 70153 504/822-1611

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IN THE
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FEDERAL ENERGY REGULATORY COMMISSION,
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PENNZOIL PRODUCING COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF OF WILLIAMS, INC., ET AL.
AS AMICI CURIAE*

INTEREST OF AMICI CURIAE

Amici are Williams, Inc. and the individual royalty owners[1] (hereinafter collectively referred to as

---

* This brief is submitted by Williams, Inc., *et al.*, as *amici curiae*, with the consent of all parties pursuant to Rule 42 of the Court.

1 Frank B. Williams, Elizabeth Williams, Ann J. Marsak, Alec Andrew Johnson, Succession of Mrs. Delphine L. Williams, The Kemper and Leila Williams Foundation, Katherine W. Tremaine, Elizabeth C. Brooks, Marie L. Campbell, Allan A. Campbell, Barbara A. Campbell, Holbrook Campbell, Jr., Whitney L. Campbell, Trustee, Elizabeth Williams Trust, Lucille W. Mayfield Trust for Alec A. Johnson, Phoebe Williams Ellis, and Whitney National Bank of New Orleans, Trustee.

"Williams") who are parties to the settlement agreement with Pennzoil Producing Company (Pennzoil) and Shell Oil Company (Shell) that is the subject matter of this case. Because the settlement shall take effect only upon approval by the Federal Energy Regulatory Commission (Commission) of one of the two alternative procedures set forth in the settlement agreement, *amici* are directly affected by the outcome of this case.

In 1934 Williams, Inc. (then F. B. Williams Cypress Company, Limited) entered into a Mineral Lease with Shell (then Shell Petroleum Corporation) covering substantial acreage owned by Williams, Inc. in South Louisiana. Included under the 1934 lease was a block of acreage in Terrebonne Parish, Louisiana that subsequently became an oil and gas field known as Gibson Field. In 1942 Shell subleased to Pennzoil (then Union Producing Company) its rights in the gas and certain other hydrocarbons to be produced under the 1934 lease. In 1952 Shell acquired a lease from Williams covering a twenty-acre tract within Gibson Field.

The 1934 lease requires the lessee to pay gas royalties on the basis of one-eighth of the *value* thereof, calculated at the *market rate* prevailing at the wellhead. The royalty clause in the 1952 lease is substantially the same, except that the fraction is one-fourth rather than one-eighth. Beginning in 1972 the landowners adjacent to Williams began receiving gas royalties on a considerably higher basis per Mcf than Pennzoil and Shell were paying to Williams. Demands were made by Williams on Pennzoil and Shell to increase royalty payments to reflect actual market value of the gas being produced from Gibson Field. Pennzoil and Shell responded by asserting that they were paying gas royalties on the basis of a percentage of proceeds received by them under gas sales contracts with United Gas Pipe Line Co. (United) and that such payments satisfied their obligations under the leases.

The parties were unable to resolve their differences, and in March 1974 Williams made formal demand on the lessees, in accordance with the leases, to make up the deficiencies or suffer cancellation of the leases. Shell and Pennzoil then immediately brought an action for an injunction and declaratory judgment in the Civil District Court for the Parish of Orleans, Louisiana[2] (hereinafter "the state court litigation"), and Williams responded by asserting a counterclaim for cancellation of the leases and damages for the underpayment of royalties.

After extensive discovery in the state court litigation, Pennzoil, Shell and Williams entered into a settlement agreement on June 18, 1975, which provided for a compromise of the Williams' demands, subject to approval by the Commission either to permit Pennzoil and Shell to pass to United through the increased royalty cost resulting from the settlement, or to permit the lessees to abandon in kind the fractional royalty interest to Williams for sale in the intrastate market. As a condition of the settlement, the state court litigation was stayed pending the proceedings before the Commission. Because of the delays in-

2 *Shell Oil Co. and Pennzoil Producing Co. v. Williams, Inc., et al.*, Docket No. 573-591 (May 24, 1974).

curred in the proceeding before the Commission, the stay of the state court proceeding has been lifted,[3] and the parties have engaged in further discovery.

Amici join Pennzoil and Shell in urging this Court to affirm the decision of the Court of Appeals for the Fifth Circuit. If the Commission does not approve the relief requested, Williams will certainly continue with the state court litigation. Therefore, Pennzoil and Shell are in the uncomfortable position of not being able candidly to assert to this Court the full extent of their perilous condition in the state court litigation for fear of the effect of their statements on that litigation. Williams, however, is not so constrained.

ARGUMENT

Williams, as *amici curiae*, will not attempt to respond to each argument raised by the Commission, leaving that task to Pennzoil and Shell. We will address ourselves to the two major objections of the Commission, namely, (1) the relationship between the royalty costs incurred by Pennzoil and Shell under the settlement and the "unregulated market," and (2) the reasonableness of the settlement.[4]

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3 The settlement agreement provided that either the plaintiffs or the defendants could terminate the settlement if the Commission refused or failed to issue the necessary authorization by February 1, 1976. On February 6, 1976 the parties to the state court proceeding filed a joint motion to vacate the stay order, without terminating the settlement agreement.

4 The reasonableness of the settlement was not an issue in the Court of Appeals because the Commission below had determined that it lacked authority to permit relief under any circumstances, though the Commission expressed sympathy for the plight of Shell and Pennzoil. *The reasonableness of the settlement is raised here by the Commission for the first time in any judicial forum.*

I. Royalty Costs Resulting From The Settlement Are Not Based On Or Tied To The Unregulated Intrastate Market For Natural Gas, But Are Tied To The National Rate Set By The Commission.

The Commission has erroneously characterized the basic issue presented by this case, and its primary argument is based on the same misconception. The Commission states that the first question presented is "[w]hether the Natural Gas Act permits the Commission to establish rates for the interstate sale of natural gas that pass through to interstate consumers *royalty costs based on the unregulated price of natural gas in the intrastate market.*" (Comm. Br., p. 2; emphasis added). In its brief the Commission no less than twenty-five times states or implies that the royalties to be paid to Williams under the settlement are "based on" or "tied to" the unregulated price of natural gas in the intrastate market. These contentions are contrary to the plain wording of the settlement agreement and completely misinterpret the intentions of the parties to the settlement. The error is indeed grave in that it forms virtually the entire basis for arguments urged by the Commission, relying on its interpretation of *Texaco Inc. v. FPC*, 417 U.S. 380 (1974).

The royalty to be paid to the lessor under the settlement agreement of June 18, 1975 is the higher of 78¢ (plus 1.5¢ per Mcf annual escalations commencing January 1, 1976) or 150% of the highest area or national rate authorized by the Commission, plus Btu and tax adjustment. The 78¢ represented 150% of the then effective national rate set by the Commission. The

150% figure was not arbitrarily arrived at by the parties; it represented the same percentage of the national rate that the Commission in a then pending rulemaking proposal sought to permit small producers to collect.[5]

Subsequent to execution of the settlement agreement, the Commission adopted Opinion No. 770-A, which increased the national rate from 52¢ to $1.42 per Mcf. In order to take into account the effect of the substantial rate increase, Williams agreed to modify the settlement agreement to provide the basis for payment of royalties after July 26, 1976 (the effective date of Opinion 770-A) will be the higher of 78¢ as escalated or *100%* of the highest area or national rate. The settlement as revised was patterned after and almost identical to a proposed settlement then pending before the Commission for approval between El Paso Natural Gas Company and royalty interest owners in West Texas. That settlement was subsequently approved by the Commission and declared to be "reasonable and proper and in the public interest in carrying out the provisions of the Natural Gas Act." *El Paso Natural Gas Co.*, Docket Nos. RP 72-105, *et al.* (Feb. 16, 1977), at 24.[6] The Commission's position here is inconsistent with its approval of the *El Paso* settlement.

5 Small Producer Regulation, Notice of Proposed Rulemaking, Docket No. R-393 (Sept. 9, 1974), 39 F.R. 33241 (1974). It appeared at the time that Williams would qualify as a small producer were it to sell gas in the interstate market.

6 The settlement agreement in the *El Paso* case provided for royalty to be paid on the basis of 40¢ per Mcf from June 1, 1974, to be redetermined each subsequent June 1 as 7¢ less than the highest base rate, adjusted for Btu, allowed by the Commission for gas produced from areas where El Paso's pipeline system in the lower 48 states is located.

If, as the Commission contends royalties payable to Williams under the settlement were tied to the free and unregulated intrastate market for gas, a substantially different result would obtain. The price of gas in the unregulated intrastate market in the South Louisiana area is substantially higher than the royalty rate that would be payable to Williams under the settlement. Based on information obtained by Williams through discovery in the state court litigation, Shell and Pennzoil were paying or receiving up to $1.40 per Mcf for gas sold in the intrastate market in the Gibson Field area through the date of settlement (June 1975). The market value claim of Williams for the period subsequent to June 1975 is substantially above the 1975 amounts.[7]

Contrary to the repeated assertions of the Commission, the royalty payable to Williams under the settlement agreement is not based on or tied to the unregulated intrastate market,[8] but is expressly tied to

7 In *Kingery v. Continental Oil Co.*, 434 F. Supp. 349, 351 (W.D. Tex. 1977), a federal district court held that the market price for gas in a field in West Texas, based on expert testimony, was $1.90 per Mcf in 1976 and $2.00 per Mcf in 1977. We anticipate from information obtained in discovery in the state court litigation that similar values can be substantiated in South Louisiana.

8 The Commission reasons that the settlement is "based on" the unregulated market because the settlement reflects a claim for royalties based on the unregulated market (Comm. Br., p. 14). This argument not only defies logic, but is factually inaccurate. Regardless of the nature of the claim, the settlement is based upon the regulated market. In any event, the Commission's description of the nature of the *claim* is inaccurate.

The Williams leases require the payment of royalties calculated at the market value of gas at the wellhead. Nothing in the leases requires that market value be determined solely by reference to the unregulated intrastate market. Market value is determined by the testimony of experts, who presumably take into account all relevant factors, including not only the prices in the intrastate gas market, but also the prices paid for equivalent commodities.

the highest area or national rate established by the Commission. If the settlement agreement were implemented today, it would call for payments of royalties equal to the maximum rate allowed by Commission Opinion No. 770-A rather than the higher intrastate price presently prevailing in South Louisiana.

The Commission further contends that upholding the decision of the Court of Appeals below would subject jurisdictional rates to "unpredictable fluctuations and escalations that are beyond the control of the Commission" (Comm. Br., p. 21). If royalties payable under the settlement were in fact based on or tied to the unregulated intrastate market, unpredictable fluctuations might be possible. But in the settlement presented to the Commission in this proceeding, the royalty rate is expressly tied to the Commission's own rate, so that the royalty cost shall be directly controlled by the Commission.

Thus, the entire basis for the Commission's reliance on *FPC v. Texaco Inc.* is absent. But there is even a more fundamental reason why the *Texaco* decision is inapplicable. The Court in *Texaco* held invalid a proposed Commission order that would exempt from regulation under the Natural Gas Act all gas sales made by small producers. The only exception to total deregulation of small producers was a provision in the order that refused to permit "tracking increases" by pipelines purchasing from small producers to the extent that rates charged by the small producer were "unreasonably high" considering appropriate comparisons with highest contract prices charged by

large producers or the prevailing market price in the intrastate market. 45 FPC 454, 457 (1971).

The proposed order invalidated by the Court in *Texaco* would have exempted from regulation a group of producers who were admittedly subject to regulation by the Natural Gas Act. Landowners-lessors such as Williams, unlike small producers, are not subject to regulation under the Act. *Mobil Oil Corp. v. FPC*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied*, 406 U.S. 976 (1972). It is well established, and the Commission apparently concedes (Comm. Br., p. 37, n.22), that the payment of rent or royalties by the lessee to a landowner, in the form of a percentage of the value of the product extracted, is not a "sale" of that product by the lessor to the lessee. The rent or royalty paid to the landowner-lessor is a cost of exploration to the lessee, which if reasonably and prudently incurred should properly be passed on to the ultimate purchaser of the product. We submit that the record supports the reasonableness of the increase in royalty costs incurred by Pennzoil and Shell as a result of the settlement.

II. The Settlement Agreement Reflects A Reasonable Compromise Between The Producers And Royalty Owners Based On Known Litigation Risks; Accordingly, The Rate Increase Resulting From Passing Through The Additional Royalty Cost Is Reasonable.

The issue before this Court is whether the Commission has authority to adjust the rate of an independent

natural gas producer to reflect increased royalty costs resulting from the proposed settlement with the royalty owners, as it is now doing for pipeline companies regulated under the same statute. *El Paso Natural Gas Co., supra* note 6. This case does not involve a determination of the merits of the state court litigation. Thus, the issue of whether lessors under a market value lease are entitled to be paid royalties based on the market value for gas in excess of Commission price ceilings, or whether they are limited to price ceilings fixed by the Commission, is not before this Court.

The merits of the state court litigation are involved in this case only insofar as the litigation risks are involved in determining whether the settlement is reasonable. As pointed out by the Court of Appeals, the Commission has authority to consider the reasonableness of any costs incurred. *Pennzoil Producing Co. v. FPC,* 553 F.2d at 488. The Court of Appeals found that Shell and Pennzoil were put in a "bind" as a result of the state court litigation, and that they had a right to seek individualized relief from the Commission to relieve the bind. *Id.*

Although the royalty owners have a vital interest in the outcome of this proceeding, the nature of this proceeding has precluded their presence and representation. Because the position of the royalty owners is opposed by the Commission, Pennzoil and Shell, the only parties to this proceeding, there has not been presented to the Commission or the Court of Appeals a full assessment of the litigation risks to Pennzoil and Shell in the state court litigation. While the producers

have indicated that the proposed settlement is fair and reasonable, they are not in a position to show the strong position of Williams in the state court proceeding for fear that their statements might prejudice their cause in the state court. As a result, the Commission in its brief contends that Pennzoil and Shell cannot be assumed to be in a bind, and further that courts are divided on the "market value" issue (Comm. Br., p. 35). The Commission then repeats the unsupported speculation of the administrative law judge below that "[i]t is highly doubtful that Williams would prevail on its claim that 'market value' for basing royalty payments means a price in excess of the Commission established area and nationwide ceiling prices." *Id.* The Commission's attempt to discredit or discount the litigation risks that faced Pennzoil and Shell in June of 1975, and that face them now if the settlement is not approved, cannot be left unchallenged.

The settlement agreement reached by Pennzoil, Shell and Williams in June of 1975 resulted from extensive discovery and negotiations. Facts developed through discovery and the emerging case law interpreting market value clauses in leases weighed heavily in favor of Williams. Evidence developed through interrogatories, depositions and document production in the state court litigation do in fact support the following assertions of Williams:

1. The dedication of gas produced from the lands of Williams, Inc. in Gibson Field, Louisiana to interstate commerce resulted solely from the decision and actions of the lessees, Shell and Pennzoil, without seeking the advice and consent of the lessor, Williams, Inc.

2. There existed at the time of the dedication of the gas to interstate commerce a substantial intrastate market for the gas, the City of New Orleans, and gas produced from other nearby fields were directed by Pennzoil to this intrastate market, while the gas produced from Gibson Field was arbitrarily committed to a contract with Pennzoil's then affiliate, United Gas Pipe Line Co., for resale in the interstate market.

3. Between 1971 and the present, both Shell and Pennzoil have sold gas produced from lands of others in Gibson Field and adjacent gas fields in the intrastate market at substantially higher prices per Mcf than the rates used in calculating royalties paid to Williams.

The results of a judgment against Pennzoil and Shell in the state court litigation would be dire. The primary relief requested by Williams is lease cancellation, plus damages for the underpayment of royalties until the leases are released to Williams. Thus, the respondents could face a large money judgment and the loss of revenues from Gibson Field in the future. If the state court were to deny lease cancellation but award Williams damages to compensate for the difference between the market value of gas royalties and the royalties actually paid, Pennzoil and Shell would undoubtedly sustain a substantial loss from their operations in Gibson Field. Furthermore, under the Louisiana Mineral Code, the court may award as damages *double* the amount of royalties due, plus interest and attorneys' fees, regardless of the

cause of the failure to pay royalties. La. R.S. 31:140 (1974).

Assessing litigation risks for settlement purposes involves applying the existing jurisprudence to the facts of the particular case. The Commission has not cited one case that actually supports its statement that the courts are divided on the interpretation of market value royalty clauses in leases. To the contrary, the overwhelming conclusion of federal and state courts is that gas royalties payable to lessors under market value royalty clauses are not subject to rate ceilings set by the Commission.

In *Denman v. J. M. Huber Corp.*, 251 F. Supp. 746 (N.D. Tex. 1964), lessors sued the lessee for the continuing breach of contractual obligations under royalty clauses of three leases, contending that the lessee refused to pay royalty gas at market price or market value but instead paid only the amount received from the pipeline company for the gas. The court held that the royalty owners were legally entitled to collect royalties from the lessee computed at the market value or market price in excess of the applicable effective rate under the Natural Gas Act pursuant to the rules and regulations of the Commission. On appeal, the Fifth Circuit Court of Appeals affirmed that portion of the district court's holding, but remanded the case and instructed the district court to refrain from fixing "market price" of gas pending an invocation by the parties of a ruling from the Commission as to its jurisdiction over rates to be paid for gas royalty. *J. M. Huber Corp. v. Denman*, 367 F.2d 104 (5th Cir. 1966). Thereafter, the royalty owners petitioned the Com-

mission for a declaratory order disclaiming jurisdiction. The case was consolidated with similar cases, and the Commission subsequently ruled that the royalty provisions of oil and gas leases constituted sales of natural gas for resale in interstate commerce, subject to the provisions of the Natural Gas Act. FPC Opinion No. 562, 42 FPC 164. On appeal, the Court of Appeals for the District of Columbia reversed the Commission ruling and specifically held that royalty provisions in leases entitling royalty owners to a percentage interest in gas sold did not constitute sales of natural gas in interstate commerce subject to the Natural Gas Act and, accordingly, royalty owners were not subject to Commission regulation. *Mobil Oil Corp. v. FPC,* 463 F.2d 256 (D.C. Cir. 1971), *cert. denied,* 406 U.S. 976 (1972). Further the court stated:

> To avoid any misunderstanding we interject that we have not been made uneasy by the contentions the producers have presented to us, *for we see no theoretical impediment to producers' being held on the basis of a contract to a royalty payment related to a base higher than the producers' filed rate* . . . . In any event, we are not persuaded that the maintenance in either state or federal courts of contract (lease) controversies between royalty owners and lessees will undercut the Federal regulatory system. 463 F.2d at 264-65 (emphasis added).

Other federal decisions have recognized that the royalty obligations of producers are not governed by the Commission but rather by state law. *Placid Oil Co. v. FPC,* 483 F.2d 880, 911 (5th Cir. 1973); *In re Other*

Southwest Area Rate Case (OSWAI), 484 F.2d 469, 471, n.3 (5th Cir. 1973).

In *Foster v. Atlantic Refining Co.,* 329 F.2d 485 (5th Cir. 1964), the lessee in 1950 entered into a twenty-year gas sales contract calling for a price that was admittedly the market price at that time. Subsequently the prevailing price in the field rose substantially above the escalated price provided in the gas sales contract. The Fifth Circuit rejected the argument that the market price for determining royalty under a lease was the market value of gas at the time the lessee entered into the long-term gas contract.

> The inability of Atlantic to make its gas sales contract with escalation provisions is beside the point. The obligation of Atlantic to pay royalties is fixed and unambiguous. It made the gas sales contract with full knowledge of this obligation and did nothing to protect itself against increases in price. The fact that its purchaser would not agree to pay the market price prevailing at the time of the delivery does not destroy the lease obligation . . . When it made the gas sales contract, Atlantic took the calculated risk of that contract producing royalties satisfactory to the lease terms. The fact that increases in market prices have made the lease obligations financially burdensome is no defense.
>
> * * *
>
> . . . The lease calls for royalty based on the market price prevailing for the field where produced when run. The fact that the ascer-

tainment of future market price may be troublesome or that the royalty provisions are improvident and result in a financial loss to Atlantic "is not a web of the court's weaving." Atlantic cannot expect the court to rewrite the lease to Atlantic's satisfaction. 329 F.2d at 489-90 (quoting *Phillips Pet. Co. v. Bynum*, 155 F.2d 196, 198 (5th Cir.), *cert. denied*, 329 U.S. 714 (1946)).

In *Texas Oil & Gas Corp. v. Vela*, 405 S.W.2d 68 (Tex. Civ. App. 1966), *reformed*, 429 S.W.2d 866 (Tex. 1968), the lessee urged that the lessor should be bound by the market value of gas existing at the time the lessee committed the gas to a sales contract. The court found persuasive the holding in *Foster* that the lessors were not parties to the gas sales contract and the terms thereof did not change the lessee's obligation to pay the market price of the gas. The court stated:

> It is elemental contract law that since the lessor is not a party to the gas purchase contract entered into between the lessee and a third party, he is not bound by the terms of same, if they are in conflict with lessee's obligation under the lease . . . .
>
> In our opinion the proper rule is that the price paid under a gas purchase contract entered into between lessee and a third party is not necessarily the "market price" as provided for in the lease. 405 S.W.2d at 74.

The court noted its interpretation of *Foster:*

> It was held in *Foster* that since the lessors were not parties to the gas sales contract, the terms of the contract did not change the lessee's obligation under the lease to pay the "market price." This obligation was fixed and unambiguous, and lessee was required to carry out same, however troublesome to ascertain or financially burdensome. 405 S.W.2d at 73.

On appeal to the Texas Supreme Court, that court expressed general agreement with the conclusion of *Foster* that even though the lease obligations may prove financially burdensome to a lessee who has made a long-term contract without protecting itself against increases in market prices, the lessee was bound to pay market price. 429 S.W.2d at 871.

In *Vela*, the lessors executed their original lease in the year 1933, only one year before Williams granted to Shell the primary lease in question in this case. The Natural Gas Act of 1938 was several years from enactment and the *Phillips* decision of the United States Supreme Court upholding the jurisdiction of the Commission was then two decades away. In *Vela*, natural gas was selling for only 2.3 cents per Mcf at the time of execution of the lease. The court ruled that the lessees were bound to pay the then existing market price of 13 cents per Mcf. The court quoted from *Foster:*

> When it made the gas sales contract, Atlantic [the lessee] took the calculated risk of that

> contract producing royalties satisfactory to the lease terms. The fact that increases in market prices have made the lease obligations financially burdensome is no defense. 429 S.W.2d at 871 (quoting *Foster*, 329 F.2d at 489).

The position of Williams in the state court litigation has been significantly enhanced by the cases in this area decided subsequent to the 1975 settlement. In *Kingery v. Continental Oil Company*, 434 F.Supp. 349 (W.D. Tex. 1977), appeal docketed, involving a 1944 market value lease, the court relied on *Vela, Foster, Huber* and *Mobil* to hold that gas royalties based on market value would be determined at the time the gas was sold and not at the time the lessee committed the gas to a long-term contract, and that the market value of gas was properly determined by evidence of specific sales of gas and contract negotiations for the sale of gas in the immediate vicinity of the lease, unfettered by rate ceilings fixed by the Commission.

> Collection of royalties at a rate in excess of that established by the Federal Power Commission does not subvert the purpose of the Natural Gas Act nor undercut the Federal Regulatory System. 434 F. Supp. at 355.

The court in *Kingery* found the market value of gas, based on expert testimony, to be as follows:

> A. For the year 1972, \$.28/mcf.
> B. For the year 1973, \$.55/mcf.
> C. For the year 1974, \$1.25/mcf.
> D. For the year 1975, \$1.85/mcf.

> E. For the year 1976, \$1.90/mcf.
> F. For the year 1977, \$2.00/mcf.
>
> 434 F. Supp. at 351.

The Supreme Court of Kansas has reached a similar result in *Lightcap v. Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1, *cert. denied*, 434 U.S. 876 (1977), petition for rehearing pending. The court in *Lightcap* held that "the existence of federal regulation over the rates which a gas producer may receive is no obstacle to the fixing of a higher rate as the 'market value' of the gas it sells for the purpose of computing royalties." 562 P.2d at 8. With respect to the claim by the lessee that the maximum rate imposed by the Commission puts a ceiling on the royalty cost the lessee may incur, the Kansas Supreme Court stated:

> [T]he process begins at the other end. The royalties to be paid are first to be determined under state law, based on the terms of the lease. The royalties so determined then become a component cost, to be considered by the FPC in determining the rates it will permit Mobil to charge. In this respect royalties paid are costs to a gas producer in the same way as fuel bills are costs to an electric utility. Neither cost is directly under the jurisdiction of the utilities regulatory agency, but both are considered in the agency's rate making function. *Id.*

In the face of the overwhelming authority to the contrary, the Commission claims that the courts are "divided" on the issue and quotes the administrative

law judge's opinion that it is "doubtful" that Williams would prevail on its claim (Comm. Br., p. 35). As authority for the division of authority the Commission cites *Mobil Oil Corp. v. FPC, supra*, and *Whitehall Oil Co. v. Boagni*, 255 La. 67, 229 So.2d 702 (1969). The *Mobil* case specifically held that the Commission's rate-making jurisdiction does not extend to the landowner's lease or its royalty payments, and stated that it was not persuaded that contract controversies between royalty owners and lessees would undercut the federal regulatory system. 463 F.2d at 263, 265. The court did speculate in dictum that a lessor's claim for royalties might be considered by a court to run counter to the intention of the parties, but added:

> The question might be obviated in a particular case if the court discerned an intrastate market, capable of absorbing the volumes involved, not subject to any Federal ceiling. 463 F.2d at 265, n.24.

Clearly under the present dispute between Williams and the appellees, with a intrastate market available, the court's dictum is not applicable.

The Commission cites *Whitehall Oil Company v. Boagni* as an indication of the view of the Louisiana Supreme Court that "the 'market value' of gas sold for resale in interstate commerce can be established only by reference to the just and reasonable rate set by the Commission." (Comm. Br., p. 5, n.4). Quite to the contrary, the *Whitehall* case did not involve the issue of market value royalties, but whether a lessor was obligated under the lease to refund to the lessee

amounts that the lessee had to refund to its pipeline purchaser pursuant to an order of the Commission. Under the lease in question, the lessee was *obligated* to sell the lessor's gas *for the same price and under the same terms* as it sold its own. The Commission's argument that the Louisiana Supreme Court equated market value of gas to the Commission's regulated rates, under the facts of the *Whitehall* case, is totally without basis.

The real issue for the Commission, however, was not a determination of whether Pennzoil and Shell or Williams would prevail in the litigation. Rather, the Commission should have focused only on whether, considering all circumstances, Pennzoil and Shell acted prudently and reasonably in executing the settlement. The Commission has since stated this to be the proper focus of its consideration. *El Paso Natural Gas Co., supra*. The record below establishes beyond doubt that Pennzoil and Shell acted reasonably and prudently in executing the settlement agreement, and no one has challenged that fact. Had the Commission then considered the matter as it has subsequently in *El Paso* acknowledged it should, it would have granted the relief requested.

In summary, Shell and Pennzoil were indeed placed and remain in a difficult bind in the state court litigation. The settlement reached with Williams was prudent on the part of Pennzoil and Shell, considering the litigation risks facing them. The contention by the Commission that the respondents were not in a bind, or that the settlement was not reasonable, or that the increased rate resulting from the settlement was not

reasonable, is contrary to the record and did not form the basis of the Commission's decision.

CONCLUSION

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

CAMPBELL C. HUTCHINSON
ANTHONY M. DiLEO
Stone, Pigman, Walther,
Wittmann & Hutchinson
1000 Whitney Building
New Orleans, Louisiana 70130
Telephone: (504) 581-3200

Counsel for Williams, Inc., et al., Amici Curiae

CERTIFICATE OF SERVICE

I hereby certify that on the ____ day of October, 1978, three copies of the foregoing brief of Williams, Inc., et al, Amici Curiae, were served upon the following counsel of record by placing them in the United States mail, postage prepaid, addressed to:

JERON L. STEVENS, Esquire
STEPHEN M. HACKERMAN, Esquire
Baker and Botts

3000 One Shell Plaza
Houston, Texas 77002

THOMAS G. JOHNSON, Esquire
JOSEPH H. FIELDS, Esquire
Shell Oil Company
P. O. Box 2463
Houston, Texas 77001

WILLIAM B. CASSIN, Esquire
Executive Vice President &
General Counsel
PHILLIP D. ENDOM, Esquire
Vice President &
Associate General Counsel
LEE M. HUBER, Esquire
700 Milam
P. O. Box 1478
Houston, Texas 77002

WADE H. McCREE, JR.
Solicitor General
Office of the Solicitor General
Department of Justice
Washington, D.C. 20530

DONALD R. ARNETT, Esquire
Austin and Arnett
1938 Bank of the Southwest Building
Houston, Texas 77002

I hereby certify that all parties required to be served have been served.

____

In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION,
Petitioner,

vs.

PENNZOIL PRODUCTION COMPANY, ET AL.,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF OF LAWRENCE LIGHTCAP AND WILLIAM T. LIGHTCAP (SUBSTITUTED FOR HARRY AND LELA LIGHTCAP), ET AL., AS AMICI CURIAE

*DALE M. STUCKY
GERRIT H. WORMHOUDT
P. O. Box 997, 125 N. Market
Wichita, Kansas 67201

Of Counsel:
KRAMER, NORDLING & NORDLING
P. O. Box 250
Hugoton, Kansas 67951

MARK E. SINGER
GREGORY J. STUCKY
FLEESON, GOOING, COULSON & KITCH
P. O. Box 997, 125 N. Market
Wichita, Kansas 67201

*Counsel upon whom service is to be made.

E. L. MENDENHALL, INC., 926 Cherry Street, Kansas City, Mo. 64106, (816) 421-3030

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to receive the consideration bargained for by them in exchange for the extensive bundle of exclusive rights granted producers of natural gas, authorizing exploration upon, drilling into, laying of lines across, and numerous other related activities essential to the mining of lands potentially productive of natural gas.[2]

In the instant proceedings, No. 77-648, such landowner-lessors' common law rights are sought to be subjected to regulation by the Federal Energy Regulatory Commission ("Commission") in the complete absence of, and with apparent disregard for, the persons whose contractual rights may be affected. No landowner-lessors are now, or ever have been, parties to these proceedings, although their interests could be drastically affected by judicial response to the hypothetical issues propounded herein by the symbiont parties of record. Such parties, the petitioning federal agency administering sales of natural gas for resale in interstate commerce, and three of its regulatees, appearing here ostensibly as respondents, along with other regulatees which appeared in the court of appeals below, have a common interest in opposing the enforcement of such common-law contracts in accordance with their terms.

2. The conventional lease provides that the lessee has the exclusive right to explore and produce oil, gas and other hydrocarbons from the land. The landowner-lessor does not participate in those activities which reduce the minerals to possession, is not entitled to any of the profits resulting from those activities, and does not own any natural gas which the lessee reduces to possession. The owner of the lease, the lessee or his assigns, has legal title to all products resulting from the mining and manufacturing activities on the land, which result for the first time in personal property—natural gas which can become the subject of commerce. For a brief review of undisputed facts concerning the contractual rental arrangements embodied in a conventional oil and gas lease, see Brief of Respondents in Opposition, *Mobil Oil Corp.* v. *Harry Lightcap, et al.*, No. 76-1694, p. 3, n. 2.

By its choice of words, the Commission discloses a basic misunderstanding of the lease agreement. The Commission consistently refers to "royalty gas," "gas attributable to Williams' royalty interest" and phrases of like import. (Brief for the Federal Energy Regulatory Commission, pp. 6, 7, 8, 9, 10, 11, 15, 37, 38 and 40). "Royalty gas," under a conventional lease (as distinguished from overriding royalty carved out of the lessee interest and assigned by lessee, and gas delivered in kind to the lessor, both creating an ownership interest in the produced gas stream itself), does not exist, although the phrase may be sometimes used as a shorthand expression to describe that part of the lease rental computed as royalty related to the volume of production. Such use by the Commission of such phrases in the context of this case merely confuses the legal relationship between the lessor and lessee because it conveys the false impression that the lessor has an ownership or possessory interest or power of disposition in a portion of natural gas produced pursuant to a lease on his land.

Amici curiae, respondents in *Mobil Oil Corp.* v. *Harry Lightcap, et al.* (*"Lightcap"*), Case No. 76-1694, are lessors among that handful on whose lands leases have been construed by the Supreme Court of Kansas to entitle them to recover monthly cash rental, denominated as royalty, payable for the mining activities aforesaid in dollar amounts consisting of a stated fraction of the market value of gas found by lessee and turned by it, each such month, into personal property which can become a commodity of commerce in commercial quantities.

These landowner-lessors obtained judgment from the Supreme Court of Kansas on their contract claims against Mobil Oil Corporation, petitioner in *Lightcap*, some 15 years after suit was commenced. Such judgment was delayed for most of that period due to the unsuccessful, combined efforts of Mobil, Shell Oil Company ("Shell," a respondent herein) and numerous other federally-regulated natural gas producers to subject farmers to regulation by the Commission, petitioner in the instant case, No. 77-648. Without detailing here the history of such efforts,[3] suffice it to say that the supposed antagonists

3. The Brief of Respondents in Opposition, *Mobil Oil Corp.* v. *Harry Lightcap, et al.*, No. 76-1694, pp. 2-13 contains a detailed history of such prior efforts.

here were aligned together as parties of common interest in the federal judicial and administrative proceedings brought to forestall the state court judgments in *Lightcap*. Those efforts culminated in denial of certiorari by this Court to review the holding in *Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1972) that neither these very landowners (*amici curiae* here), nor the leases on their lands, nor the monthly cash payments required to be made to them under the leases are subject to federal regulation. *Mobil Oil Corp.* v. *Matzen*, 406 U.S. 976, *reh. denied* 409 U.S. 902 (1972). Such alignment still persists, as shown by the joint efforts of the Commission and Mobil to obtain rehearing of denial of certiorari in *Lightcap*[4], notwithstanding the ostensibly adversary positions assumed in this Case No. 77-648 by the Commission and Shell, former joint proponents with Mobil of federal regulation of such royalty in the prior proceedings aforesaid.[5]

As will be specifically demonstrated, the regulatee respondents in the instant proceedings are pecuniarily indifferent to the outcome herein, but are willing cohorts of their visitorial adversary, the Commission, appearing as petitioner here, in its continuing efforts to avoid the established principles governing the rights of landowner-lessors under oil and gas leases.

4. The Commission has urged this Court three times to reverse the Kansas Supreme Court's decision in *Lightcap* v. *Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1 (1977), *cert. denied* 434 U.S. 876 (1978), *rehearing pending*. Memorandum for the Federal Energy Regulatory Commission as *Amicus Curiae* in Support of Rehearing, *Mobil Oil Corp.* v. *Harry Lightcap, et al.*, Case No. 76-1694; Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit, p. 10, n. 6; and Brief for the Federal Energy Regulatory Commission, pp. 35-37, the latter two filed in the instant proceedings.

5. At the request of the Court in *Lightcap*, made the same day that the petition for writ of certiorari was granted in the instant proceedings, *amici curiae* have filed in *Lightcap* their Memorandum of Respondents in Opposition to Petition for Rehearing, *Mobil Oil Corp.* v. *Harry Lightcap, et al.*, Case No. 76-1694.

The interests herein of landowner-lessors, the persons here whose rights are at stake, are obvious. It is sincerely hoped that the handicapped, limited presence of a few of such persons, as *amici curiae*, may be of some assistance in providing proper perspective regarding the actual nature of these proceedings and their appropriate disposition.

STATEMENT OF THE CASE

These present proceedings are collateral to, but procedurally and jurisdictionally wholly independent of, a Louisiana state lawsuit which has not been tried, is not stayed, and is still pending. The relief sought before the Commission below by respondents Pennzoil Producing Company ("Pennzoil") and Shell came in the garb of a proposed, but unconsummated, settlement of unadjudicated claims of uncertain outcome in such state court proceedings. The state court lawsuit is between Williams, Inc. ("Williams"), a lessor (who is not a party to these proceedings and was not a party to the Commission proceedings below or in the review proceedings in the court of appeals) and its lessees, respondents Shell and Pennzoil. The state court action involves the construction of a clause in two oil and gas leases owned by Pennzoil and Shell, as lessees. That clause specified periodic cash rentals, computed as royalty, payable by reason of lessees' exercise of the right and privilege of producing gas in paying quantities. The clause provides for such cash rental equal to fixed fractions of the "value" of all of the natural gas produced.[6]

6. Natural gas is valued on a per Mcf basis. One lease provides that such "value" is to be "calculated at the market rate prevailing at the well," while the second provides that such "value" is to be "calculated at the market price prevailing at the well." (A. 133, 145). The fixed fraction of such value is 1/8th in one lease and 1/4th in the other lease. (A. 133, 147).

The lessees, respondents Pennzoil and Shell, also happen to be natural gas companies subject to regulation by the Commission under the Natural Gas Act. They claim in that state court litigation that, by making payments to their lessor of such fixed fractions of the dollar amounts received by them under their regulated cost-of-service rates established for them by the Commission, they have discharged their contractual lease obligations, if properly construed, to pay such rental required to be computed by reference to the "value" of the natural gas. (A. 93). Williams asserts in the pending state court suit that the lessees Shell and Pennzoil have not fulfilled the rental obligations under their leases. (A. 112). A justiciable controversy thus exists in the state court between lessor and lessee, both parties to that lawsuit, over the measure of the royalty obligation under the leases.

The lessees, Pennzoil and Shell, managed to secure the conditional agreement of their lessor to settle that state court litigation upon the occurrence of either of two contingent events. Under the first alternative, they obtained their lessor's agreement to amend the lease to provide for computation of such royalty by use of a per Mcf factor equal to the highest allowable area or national rate for independent producers of gas,[7] if and only if, those lessees could relieve themselves completely of the resulting indebtedness. As natural gas companies, they proposed to do that by securing approval from the Commission to pass the resulting costs on to a conveniently acquiescing natural gas company, respondent United Gas Pipeline Company ("United"). (A. 16-20).

Under the second alternative, they got Williams, presently a mere lessor, to agree that it would itself become

7. *See* Brief of Respondent Pennzoil Producing Company in Opposition, p. 3, n. 4.

a natural gas company through an assignment to it of lessees' dominion and power of sale of an agreed upon portion of Shell's and Pennzoil's leasehold gas production. (A. 20-21). This second alternative would, in turn, be effective if, and only if, the Commission would authorize abandonment of such portion of the gas from the obligation of Pennzoil and Shell to continue the interstate service, which obligation Williams would otherwise assume through that assignment.

The proposed settlement agreement was presented to the Commission for approval. In its initial opinion, the Commission refused to sanction the first alternative of the proposed settlement agreement, because Pennzoil and Shell failed to show that their proposed additional costs necessitated individualized relief. (A. 32-36). Pennzoil challenged the Commission's initial opinion on the ground that it (Pennzoil) did not have an opportunity to introduce appropriate evidence to show its entitlement to individualized rate relief based on additional costs. The Commission granted both Pennzoil and Shell that opportunity. (A. 37-39).

In the subsequent evidentiary hearing before the administrative law judge, the judge concluded that Pennzoil and Shell could not demonstrate that they would be entitled to either type of relief they sought. Responding to the first alternative of the proposed settlement agreement, the administrative judge held that the evidence offered by Shell demonstrated that Shell could absorb the proposed additional payments which would arise from its conditional contractual obligation to Williams if it ripened into a lease amendment, without an increase in its rate.[8] As Pennzoil

8. The administrative judge commented:

"[E]ven if it were finally adjudicated by the state courts that the market value basis for royalty payments were 78

(*Continued on following page*)

did not even attempt to introduce the evidence to show its entitlement to rate relief, which it had contended it was entitled to offer, the judge accordingly denied Pennzoil's request for individualized relief. (A. 185).

Upon review, the Commission disregarded the undisputed evidentiary findings of the administrative judge which the Commission initially thought essential to the disposition of the case. It instead denied relief on a legal theory not even considered by the administrative judge. It concluded that even if, contrary to the undisputed findings of the administrative judge, Pennzoil and Shell could otherwise show entitlement to rate relief, the Commission had no authority to grant such relief under *FPC* v. *Texaco,* 417 U.S. 380 (1974). (A. 261, 291-292). The Commission stated that it "cannot permit any incremental royalty costs resulting from this settlement, or resulting from any judgment by a state court regarding royalty payments, to be passed on to the pipeline if these incremental royalty costs are based upon any other factors than the regulated just and reasonable rate." (A. 261). It later stated on rehearing that the language relating to a state court judgment (such as is before this Court in the *Lightcap* case) was dicta, meriting no further discussion. (A. 297).

The Commission also denied Pennzoil's and Shell's alternative request for abandonment of the agreed upon

Footnote continued—

cents of $1.40 per Mcf, or some other figure, the same issues would be present here. Pennzoil and Shell would have to establish on the basis of their own costs and revenues that they could not absorb the higher royalty payments without a price increase. This, Pennzoil has not even attempted to do. And Shell has failed in its attempt." (A. 185).

Shell's own evidence indicates that if it were to absorb the full extent of its contractual debt with its lessor, Williams, based on the payment of rentals computed at $1.40 per Mcf, instead of the lower negotiated settlement price, Shell and its shareholders would still realize a profit from its Williams lease in the amount of $168,514 annually. (A. 180).

portion of the natural gas owned by them which they proposed to convey and assign to Williams because the Commission realized that Williams, under such circumstances, would, itself, become a natural gas company through such conveyance of part of the lessees' interest. The Commission, relying on its decision in *El Paso Natural Gas Co.*, 54 F.P.C. 145 (1975) (later *aff'd sub nom. California* v. *Southland Royalty Co.,* .... U.S. ...., 56 L.Ed.2d 505 (1978)), stated that in the event of acceptance by Williams of such conveyance, "Williams would not be entitled to the status afforded a royalty owner by *Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1972), but would be a natural gas company making sales for resale of natural gas in interstate commerce subject to the Commission's jurisdiction."[9] (A. 263).

The court of appeals, accepting in the very first sentence of its opinion as fact the imaginary economic hardship placed upon Shell and Pennzoil, which directly conflicted with the record facts and the findings of the administrative judge, based its opinion on that unfounded imagi-

9. *Amici curiae*, as respondents in *Mobil Oil Corp.* v. *Harry Lightcap, et al.*, Case No. 76-1694, have never claimed that they are entitled to a judicial decree of cancellation by virtue of underpayment of rental in the form of royalty. Even if they had sought cancellation, Kansas law presumably would have denied them that relief. *Davis* v. *Chautauqua Oil & Gas Co.*, 78 Kan. 97, 96 P. 47 (1908). *Amici curiae* consequently believe that they should not advise the Court on the issue of abandonment, raised in the Commission's second Question Presented. Respondents Shell and Pennzoil argue that abandonment from interstate service is required because of Williams' lease cancellation claim in the Louisiana state court litigation. *Amici curiae* concur with the Commission's statement of law, quoted above, that a lessor under a conventional oil and gas lease is not a natural gas company because a lessor does not have dominion or power of sale over any portion of the natural gas produced under his lands. If lessor agrees, like Williams, to accept an assignment of dominion and power of sale over natural gas owned by his lessees, that lessor becomes a natural gas company.

nary hardship.[10] From that wholly erroneous and imaginary factual premise, it concluded that, without rate relief, Shell and Pennzoil could not generate sufficient funds necessary for further exploration and development.[11] In their certiorari papers filed herein, the Commission and respondents simply disregarded and failed to reveal to this Court those evidentiary findings showing that Shell and Pennzoil were not entitled to relief, all in a mutual attempt to place before this Court a purportedly justiciable controversy if a writ of certiorari were granted. Only after respondents in *Lightcap, amici curiae* here, drew that fact to the attention of this Court and the Commission in *Lightcap*, after its grant of writ of certiorari herein,[12] has the Commission in its Brief finally disclosed to the Court the evidentiary findings of the administrative judge in these proceedings.[13] (A similar duplicitous change of position

10. The first sentence of the opinion of the Court below demonstrates that it decided the case on the unfounded premise that an "economic bind" existed:

> "*Caught in the squeeze* between the regulated price of its gas, which price included royalty costs at the interstate price, and the claims of landowners for increased royalty payments based on higher intrastate rates, the gas producers petitioned the Federal Power Commission for relief." *Pennzoil Producing Co.* v. *FPC*, 553 F.2d 485, 486, 5th Cir. 1977 (emphasis added)

11. *Amici curiae* have attempted to reconstruct from the record the rate of return from the sale of natural gas produced under the Williams leases, in the event Shell and Pennzoil were required to pay royalty in accordance with the terms and provisions of the settlement agreement with Williams. Such a computation is impossible to make because Shell and Pennzoil failed to introduce evidence regarding their capital costs associated with the Williams leases. (A. 177). That failure may be due to the fact that Pennzoil and Shell may have long ago recovered all such capital costs in light of continuous production over a period of more than 20 years. (A. 88).

12. Memorandum in Opposition to Petition for Rehearing, *Mobil Oil Corp.* v. *Harry Lightcap, et al.*, No. 76-1694, pp. 6-7, filed in July, 1978.

13. Brief for the Federal Energy Regulatory Commission, filed herein in September, 1978, pp. 7-8 and 33-34.

after the granting of the writ of certiorari herein, involving the status of *Mobil Oil Corporation* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1972), *cert. denied* 406 U.S. 976, *reh. denied* 409 U.S. 902-3 (1972) is discussed in footnote 19 and accompany text on pages 16-17 of this brief.)

The court of appeals was led to make a second assumption in its opinion that is also utterly contrary to the record facts. Although the court of appeals did not specifically conclude that the royalty obligations under the Williams leases required its lessees Shell and Pennzoil to pay royalty computed by reference to intrastate prices of natural gas, its opinion intimates or assumes, without any basis in law or fact, that the royalty clauses required computation of royalty solely on that basis.[14] As above stated, the proposed settlement agreement before the Commission in these proceedings would, if it became effective, modify the leases in this regard by providing for computation of periodic cash rentals computed with reference to the Commission's regulated rates.

The Commission has seized upon the two unfortunate mistakes in the opinion below and has built its entire case

14. The Court of Appeals based its conclusion that Williams demanded royalty based on "intrastate prices" from Williams' assertions in the March 27, 1974 letter it sent to respondents (A. 72-74) and its allegations contained in its Answer and Reconventional Demand in the Louisiana state court proceedings. (A. 114-115, 119-121). *Pennzoil Producing Co.* v. *FPC*, 553 F.2d 485 at 487. Williams did not disclose the method by which it calculated the values it used in those documents. In fact, it never referred to "intrastate prices" in those documents and the lessees in state court admit that Williams "set forth no theoretical basis" for such computation. (A. 92).

The Commission in its Brief here also asserts that the Williams claims were based wholly on "intrastate market values." Petitioner's Brief at p. 4. A careful review of the record does not support that assertion. Even if Williams claimed outside the record that it was entitled to royalty based on "intrastate prices," its mere assertion does not *ipso facto* establish the validity of that assertion without a state court construction of the royalty provisions in the leases.

for submission of landowner-lessors to its control on those two misstatements. Its putative adversaries, Pennzoil and Shell, in their certiorari papers, did not attempt to alert this Court to these errors.

Nor have the parties pointed out to this Court that these entire proceedings may be rendered moot at any time by unilateral action by Williams (not a party at any stage to this purported case or controversy) or by respondents, Pennzoil and Shell. The parties to the state court proceedings still pending unstayed have placed themselves in a position to play "kings-x" with this Court, depending on how things go here. The settlement agreement provides that if the Commission refuses or fails to approve the settlement agreement "or fails to issue other authorization acceptable to the parties hereto, on or before February 1, 1976," either Williams or Shell and Pennzoil may terminate the agreement by written notice to the other party. (A. 24). The unilateral termination date was extended one month until March 1, 1976. (A. 291). The agreement can be unilaterally terminated today.

In the event of termination of the conditional settlement agreement, and in the event this Court denies rehearing in *Lightcap,* the Court could in the future reach questions concerning the pass-through of so-called "market value royalties," based upon a state court judgment if, in fact, Mobil would later seek individualized relief after payment of the judgment in *Lightcap.* The judicial exception to the doctrine of mootness, embodied in the phrase "capable of repetition, yet evading review," accordingly would have no application in the event of termination of the conditional settlement agreement. *Cf., Roe* v. *Wade,* 410 U.S. 113 (1973). Likewise, the exception would have no application concerning the pass-through of so-called "market value royalties" based upon a settlement of other future or

pending "market value" royalty cases. This Court could review the action taken by the Commission in any case after a producer actually paid a settlement amount and then sought individualized relief from the Commission based on such payment. No review would be evaded.

ARGUMENT

The present posture of this lawsuit implicates the case or controversy clause, Article III, Section 2 of the Constitution, which establishes the constitutional limitation of this Court's jurisdiction. There are no legal or factual issues involved in these proceedings which can be or have been stated in terms of an actual case or controversy. By reason of this constitutional limitation, the order of this Court granting a writ of certiorari herein should be withdrawn as improvidently granted.

The Commission and respondents, by intimating as fact an imaginary hardship, based on hypothetical assumptions conflicting with the facts of record, have represented to this Court that their purported controversy, if accepted by the Court, raises justiciable questions. These proceedings are not the first time that a natural gas company has implored the Court to take cognizance of its purported economic plight hypothetically resulting from yet-to-be-performed compliance with the terms of common law lease agreements with landowner-lessors.[15] In *Mobil Oil Corp.*

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15. Petitioner in *Mobil Oil Corp.* v. *Harry Lightcap, et al.,* No. 76-1694, also makes the same unfounded claim of economic hardship as the Commission and respondents make herein. Mobil relies on various other cases filed by landowners. Reply Brief of Petitioner, *Mobil Oil Corp.* v. *Harry Lightcap, et al.,* Case No. 76-1694, pp. 1-2. Respondents cannot confirm or deny the validity of these calculations because Mobil did not introduce those calculations into the record. Respondents cannot even confirm or deny the assertion by Mobil that all the cases it lists deal with the same question raised in *Lightcap.* The first case listed, how-

(*Continued on following page*)

v. *FPC*, 417 U.S. 283 (1974), this Court also listened to the hollow economic lamentations of natural gas companies. This Court reminded those companies that "hypothetical" arguments cannot form the basis of reasoned opinions. 417 U.S. at 328. Such judicial opinions, merely advising the parties of the Court's inclination concerning issues based on a hypothetical set of facts, would necessarily exceed the constitutional limitations of the federal judiciary. *United States* v. *Freuhauf*, 365 U.S. 146 (1961). Here, Shell and Pennzoil have indicated in their certiorari papers that they not only wish the Court to grant them relief based on prophesies, as was urged in *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283 (1974), but would have the Court render an advisory opinion on the merits of an alleged controversy based on an imaginary hardship utterly disproved by the record.[16]

Footnote continued—

ever, does not address the question of additional royalty under "market value" leases. *Gray* v. *Amoco Production Co.*, 1 Kan. App. 338, 564 P.2d 579 (1977), *remanded with instructions*, 223 Kan. 441, ... P.2d ...... (1978). Even assuming that each case listed by Mobil involves an exposure to the lessee of such landowner's claims, there is nothing in this record or in *Lightcap* which shows that payment of such claims, if reduced to judgment, would require their rates as producers to be adjusted upward.

16. If this Court denies rehearing in *Lightcap*, which we believe it should, or if Pennzoil and Shell enter into a good-faith unconditional arms-length settlement of their state court litigation with Williams, and if, in any such instance, the lessee-producer later pays the judgment or settlement amount and then seeks relief from the Commission based on actual costs incurred, then and only then on review in this Court will there be a justiciable controversy regarding the various subjects discussed as hypothetical abstract propositions in these proceedings. If it is thought that the producers are pressed for time, we draw the attention of the Court to the fact that this Court's determination in *Lightcap* will affect 280 cases brought on behalf of 257 landowners filed even before Kansas had statutory class actions and that 100 of these 257 landowners are now dead, 27 of their successors are dead, and at least 4 of the third generation have, in turn, died during the litigation. Memorandum of Respondents in Opposition to Petition for Rehearing, *Mobil Oil Corp.* v. *Harry Lightcap, et al.*, Case No. 76-1694, p. 12, n. 16.

The failure to illuminate the actual facts strongly suggests that the putative adversaries herein, the regulator and its regulatees, have united for purposes other than to resolve an actual controversy between them. This is demonstrated quite vividly by their maneuvering in the certiorari papers on the question of individualized rate relief. Respondents Pennzoil and Shell artfully fashioned the legal contentions throughout these proceedings based on an imaginary set of facts, in such a manner that the Court's ultimate disposition of this lawsuit on the merits would not jeopardize their interests. On one hand, they claim that under *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283 (1974), they are entitled to an *automatic* "pass-through" of their royalty obligations without showing that such a pass-through is necessary to assure them of "just and reasonable" rates. On the other hand, they reason that this Court should abrogate the contractual obligations of their leases in such a manner as to result in the same economic effect upon them.[17] The Commission, rather than alerting this Court in its petition for a writ of certiorari herein that respondents could not show entitlement to individualized relief, instead condoned the creation of an imaginary hardship in order to induce this Court to grant a writ of certiorari herein. It now sides in its Brief with respondents' second claim that the ultimate solution to the imagined hardship requires that this Court abrogate, in a review of Commission proceedings, and with the lessor not present, the royalty clauses in the manner suggested by respondents. This lawsuit is devoid of the actual clash of adversary positions necessary for a constitutional adjudication. *Moore* v. *Charlotte-Mecklenburg Board of Education*, 402 U.S. 47 (1971).

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17. *See, e.g.*, Brief of Shell Oil Company in Opposition, p. 8, filed herein, in which Shell openly supports the Commission's view that this Court should reverse *Lightcap* v. *Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1 (1977).

The Commission urges this Court to ignore the absence of a truly adversary proceeding herein and to ignore the fact that respondents have not shown themselves entitled to the individualized relief requested. It rather urges this Court to refuse to respect state common law and instead establish a new breed of "federal law" to defeat the landowners' claim in debt.[18] The Commission's argument is founded on the false premise that the imaginary bind of the natural gas companies can be relieved only through the creation of a new species of "federal law" governing rental payments to lessors under lease contracts, which payments and lease provisions the Commission concedes in its Brief, but only after the Court has granted a writ of certiorari herein, are outside the domain of the Commission's jurisdiction. Here again, this necessary concession came only after these *amici curiae* took issue with the representations to the contrary made by the Commission to this Court before certiorari was granted herein.[19]

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18. Brief for Federal Energy Regulatory Commission, p. 37, n. 22.

19. *Amici curiae* admit that they are somewhat bewildered by the Commission's assertion that this Court should establish a new breed of federal law. The Commission, in its petition for a writ of certiorari, first suggested that this Court should reverse *Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1972), *cert. denied*, 406 U.S. 976, *reh. denied*, 409 U.S. 902-03, which decision held that the Commission has no jurisdiction (1) over lessors, or (2) over the payment of monthly cash rentals computed as royalties, or (3) over the rental provisions of oil and gas leases on their land. Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit, pp. 17-18.

After the filing by these *amici curiae* as respondents in *Lightcap*, Case No. 76-1694, of their Memorandum of Respondents in Opposition to Petition for Rehearing, which took issue with the Commission's views (p. 4 *passim*) has the Commission now unconditionally admitted its acceptance of the Court's holding in *Mobil*. It does not now press reconsideration of that case. Indeed, in its opinion below, here on review, it fully accepted and relied upon that 1971 *Mobil decision*. (See A. 260 and Brief for Federal Energy Regulatory Commission, p. 37, n. 22).

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This left-handed assertion regarding "federal law" is contrary to established law. The Court of Appeals in *Placid Oil Co.* v. *FPC*, 483 F.2d 880 (5th Cir. 1973), concluded that ascertainment of lease rental payments, computed as royalty, was not a question of federal law, but

> "an *Erie* determination of the contract stating the royalty percentage based upon the applicable principles of state law—totally beyond the control of the federal regulatory agency charged with the responsibility of regulating natural gas rates." 483 F.2d at 911.

This Court affirmed that opinion in *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283 (1974).

The Commission itself has created an imaginary bind because it has never acquiesced in or obeyed the rulings of the courts of appeal or of this Court that require royalty obligations to be treated as all other cost components entering into the rate structure of regulated natural gas companies. They did not "alter the departure point of the rate calculations" as required by *Placid*. 483 F.2d at 911. The Commission simply defiantly continues to refuse to treat what it describes as "royalty costs" as an exogenous cost, in the same manner as it treats all other production costs. All other costs entering into rates are determined by market forces, but the Commission computes the "royalty costs" as if they were derived from other combined costs, and thereby ignores the contractual obligations fixed by

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Footnote continued—

The Commission's new argument, based on "federal law," appears to be that what *Mobil* forbids it to do directly, it can do indirectly. It wishes this Court to allow it to establish the permissible extent of royalty obligations, even though the Commission has conceded in its decision below and now concedes that the parties affected by its determination are not even subject to its jurisdiction.

the terms of lease contracts.[20] The Commission could easily correct the obvious deficiencies in the application of its formula as so required by *Placid* or, at least, grant individualized relief when such application places their regulated companies in an actual economic bind. But the Commission simply refuses to follow either of those courses.

The Commission, unlike the Courts, obviously believes that landowner-lessors are only entitled to those rentals that would incidentally trickle down to them, if any,[21] through its unchanged mode of implementation of jurisdictional rates for regulated companies. But, of course, the Natural Gas Act did not nationalize landowners' property rights. *See Panhandle Eastern Pipe Line Co.* v. *Public Service Comm'n,* 332 U.S. 507 (1947). Cognizant of that fact, this Court in *Mobil Oil Corp.* v. *FPC,* 417 U.S. 283 (1974), appropriately responded to Mobil's complaint that the Commission failed to provide automatic adjustments in area rates to compensate for anticipated higher royalty costs which would conceivably result from the holding in *Mobil Oil Corp.* v. *FPC,* 463 F.2d 256 (D.C. Cir. 1972), *cert. denied* 406 U.S. 976, *reh. denied* 409 U.S. 902-3 (1972). In rejecting Mobil's claim for such automatic adjustments, this Court adopted the language of the court of appeals in responding to Mobil's contention:

> "If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief." 417 U.S. at 328 [quoting from *Placid Oil Corp.* v. *FPC,* 483 F.2d 880 (5th Cir. 1973)]

The Commission has failed to follow those directives. Had it done so, it would have denied Pennzoil's and Shell's requested rate relief on the ground that those natural gas companies could not show such entitlement. The Commission, instead, posed abstract questions by denying the requested relief on other grounds.

The Commission suggests that this Court in *FPC* v. *Texaco,* 417 U.S. 380 (1974), decided simultaneously with *Mobil Oil Corp.* v. *FPC,* 417 U.S. 283 (1974), forbids it from considering costs of natural gas companies arising from payment of their rental obligations under their lease agreements, if such costs are "based on the unregulated price of gas in the intrastate market." This abstract question is contained in the Commission's first Question Presented in both its petition for writ of certiorari and in its Brief and forms the basis for its entire extenuated argument

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20. *See, e.g., Placid Oil Co.* v. *FPC,* 483 F.2d 880, 901, n. 22, which graphically illustrates the different cost components the Commission considers in establishing area and national rates. Royalty is calculated as an endogenous cost, a percentage of the other costs, none of which have the slightest bearing on the common law obligations which lessee assumed under its lease agreement. It is well established that rentals in the form of royalty are never determined with reference to the costs incurred by the lessee in the production of natural gas. *See, e.g., Matzen* v. *Hugoton Production Co.,* 182 Kan. 456, 321 P.2d 576 (1958), *Johnson* v. *Jernigan,* 475 P.2d 396 (Okla. 1970).

21. This reflects the utter cynicism with which the big oil companies and the Commission regard the rights of farmers because they are not engaged in any way in the oil and gas business, all as is reflected by testimony in support of the Commission's actions in the *South Louisiana Area Rate Case*:

> "Q. Do you consider that the bonuses and royalties paid by the producer to the lessor or landowner constitute economic rent to the landowner?
>
> "A. (Dr. Kahn) Yes.
>
> "Q. Does that mean there should be no compensation to the landowner?
>
> "A. Do you want my opinion or—it is a little hard to know how to answer this. In my judgment, there should be *no compensation* to the landowner, or his compensation *should be taken away from him by the government.*" (Emphasis added)
>
> (Transcript of Proceedings in South Louisiana Area Rate Proceedings, p. 13,267)

based on *Texaco*.[22] There is no basis for its assertion that royalty under the Williams leases requires calculation based solely on "the unregulated price of natural gas in the intrastate market." Furthermore, the record in this case deals with a settlement agreement calling for royalty amounts calculated on the basis of federally established rates.

Even as a matter of abstract analysis, the Commission fails to distinguish between various possible bases for determination of the per Mcf or value factor entering into rental calculations. The lessor and lessee presumably could agree upon an Mcf or value factor based "solely on the unregulated price of natural gas sold in intrastate commerce." The Commission intimates that due to possible monopolistic power exerted by natural gas companies in intrastate sales, the price extracted by such companies could be distorted. It could be argued that an increment of the royalty payment made on that basis could correspondingly be attributable to such monopolistic influences. If a natural gas company attempts to seek rate relief after making royalty payments on that per Mcf basis, the Commission argues that *Texaco* forbids it from considering that requested relief. The lessor and lessee, on the other hand, could agree upon payment of rental computed with reference to the undistorted "market value" of natural

22. The Commission formulates its first Question Presented in its Brief in the following manner, with a similar formulation contained in its Petition for writ of certiorari:

> "1. Whether the Natural Gas Act permits the Commission to establish rates for interstate sale of natural gas that pass through to interstate consumers royalty costs *based on the unregulated price of natural gas in the intrastate market.*" Brief for Federal Energy Regulatory Commission, p. 2 (emphasis added)

The Commission continues to express that unfounded assumption at pages 4, 5, n. 4, 11, 12, 22, n. 13, 24, 25, 26, 31, 32, 33, 35 and 36 of its Brief.

gas. This type of royalty clause is present in *Lightcap*. Under this clause, any possible monopolistic distortions would be excluded in the determination of "market value."[23] If a regulated natural gas company demonstrates, upon a proper showing, that its payment of rental computed on that per Mcf basis requires it to seek rate relief, the Commission cannot justifiably rely on *Texaco* to deny such relief. *Texaco* does not prohibit jurisdictional rates to be calculated with reference to the undistorted "market value" of natural gas. In fact, *Texaco* actually equated the true market price of natural gas with "just and reasonable" rates which Congress under the Natural

23. The Kansas Supreme Court in *Lightcap* v. *Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1 (1977) stated:

> "Where a lease calls for royalties based on 'market value' of the gas sold, in the absence of proof of a contrary intent, that value is the price which would be paid by a willing buyer to a willing seller in a free market."

One commentator on *Lghtcap* has observed:

> "If the unregulated price of gas is subject to monopolistic influences, the 'free market value' of gas may not represent the full increment in a producer's receipts that would accrue were the gas sold without restriction." Note, *Federal Regulation of Independent Oil and Gas Producers and the Royalty Interest—a Question of Value*, 26 KAN. L. REV. 309, 318 (1978)

In other words, a "market value" lease would entitle the lessor to rentals in the form of royalty in an amount which could be substantially less than an intrastate market price distorted by monopolistic influences.

The Commission asserts that the Kansas Supreme Court in *Lightcap* held that "market value" royalty clauses refer "to the unregulated intrastate market." Petitioner's Brief at pp. 5, n. 4, and 36. This, as stated above, is a misinterpretation of the holding in *Lightcap*. The Commission further alerts this Court to *Kingery* v. *Continental Oil Co.*, 434 F.2d 349 (W.D. Tex. 1977). *Amici curiae*, unlike the Commission, cannot conclude that that Court held that a "market value" royalty clause refers to an "unregulated intrastate market." In fact, that decision never mentions the "unregulated intrastate market."

Gas Act attempted to achieve.[24] Thus, the formulation of the Commission's first Question Presented is both factually unfounded and analytically erroneous.

Due to the interposition of the proposed settlement agreement in these proceedings, the Louisiana Parish court has not had an opportunity to construe the very leases which the Commission has now construed for its own purposes in order to pose a hypothetical question to this Court. *Amici curiae* must question the propriety of the Commission's request for an advisory decision from this Court based on the Commission's unilateral construction of common-law leases in the absence of the lessor. In

24. This Court in *Texaco* recognized the distinction between "the 'true' and the 'actual' market price" of natural gas, 417 U.S. at 899, a distinction which now the Commission urges this Court to ignore. The Court in *Texaco* quoted from its opinion in *FPC* v. *Sunray DX Oil Co.*, 391 U.S. 9, 25, which stated that the "true" market price undisturbed by monopolistic forces would correspond to the "just and reasonable rate" Congress intended to achieve through the passage of the Natural Gas Act. Mr. Justice Jackson, concurring in *Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581 (1945), made the prophetic observation:

> "I should like to reverse this case, not because I think the rate reduction is wrong, but because I think that the real inwardness of the gas business as affects the future has been obscured by the Commission's preoccupation with bookkeeping and historical matter. Such considerations may be relevant to rate-base theories, but will not be satisfying to the coming generation that will look back and judge our present regulatory method in the light of an exhausted and largely wasted gas supply." 324 U.S. at 615.

The Commission, in a belated recognition of the serious problems Justice Jackson foresaw, has recently stated:

> "The commodity value of natural gas also plays a role in our price determinations. Our mandate is to achieve an adequate supply of natural gas at the lowest possible price. So long as gas is priced below its commodity value . . . there will be excess demand." FPC Opinion No. 770, ... FPC .... (1976), 10 FPS 5-295 at 5-378.

If the Commission truly believes that *Texaco* forbids it from establishing its "just and reasonable rates" calculated on the commodity or true market value of gas, it in its most recent national rate opinion ignores that belief.

essence, the Commission seeks to persuade this Court to perform the function of the Louisiana Parish court and in a manner wholly unwarranted by law or fact.

Respondents in their certiorari papers, failed to alert this Court to such inaccurate and hypothetical formulation of the Commission's First Question so presented. They have apologetically omitted to argue, before the Commission and court of appeals the merits of their absent lessor's views, explicitly and repeatedly excusing their action or inaction on the ground that they cannot be expected to carry the lessor's banner in these proceedings and then be later faced with their own printed arguments in state court.[25] They thus let the Commission's argument against the lessor go by default in a record devoid of any facts except copies of state court pleadings.

Respondents, instead, formulated an inappropriate question of their own. They argued to this Court that the question which this Court would consider on full review is whether or not they can recover prudently incurred royalty costs.[26] But, due to the conditional nature of the settlement agreement, the management of Pennzoil and Shell have relieved themselves of their management responsibility, necessary under that very theory, by shifting that management judgment to the Commission. In addition, under the settlement agreement, they have no economic exposure because they will pass on the whole economic impact of those costs. The management of Pennzoil and Shell, as well as that of United, need not exercise any judgment since, under the settlement agreement, they would not bear the economic burden. They

25. *See, e.g.*, Reply Brief of Shell Oil Company, p. 2, n. 1, *Pennzoil Producing Co.* v. *FPC*, 553 F.2d 485 (5th Cir. 1977).

26. *See, e.g.*, Brief of Respondent Pennzoil Producing Company in Opposition, pp. 1-2.

have avoided the exercise of the very management judgment which, on their own theory, must be tested by the Commission against a standard of prudence.

Another fallacy permeating the Commission's entire attenuated argument based on *Texaco* is that royalty *costs* of a regulated natural gas company may not be computed with reference to market value because, under *Texaco,* just and reasonable *rates* may not be exclusively so determined. The Commission is obviously blind to this glaring *non sequitur.* To make the argument sound, either the Commission must regulate all cost components so as to be a function of the ultimate just and reasonable rate, or else it must be said farmers sell gas in interstate commerce when they lease their lands. But the Commission admitted in its opinion below and now admits in its brief (but only after certiorari was granted), that landowner-lessors do not make sales of natural gas. The bulk of the Commission's brief assumes just the opposite of this admission.

This fallacy becomes even more apparent upon consideration of the very leases on Williams' land. In one lease, as it now exists and as proposed to be amended, the royalty is determinable as 1/8 of a value factor, while in the other, the obligation is based upon 1/4 of such a factor. Which fractional amount represents a proper cost? The Commission and the respondents have wholly ignored this question. Should the Commission be authorized by this Court to rewrite this bargained-for fraction to accord with some amount which, coupled with some per Mcf factor, will be consistent with some predetermined amount embedded in just and reasonable rates? Such questions are not rhetorical and should be openly and honestly addressed. Through addressing these questions, the Commis-

sion and respondents would reveal the legal absurdity of their mutual position regarding the per Mcf or value factor entering into the royalty calculations. But, if they were addressed, they could not be answered in this case.

This absurdity resulting from designed preoccupation with only one of the factors contained in the rental payment provisions of the conventional lease can be further illustrated. The royalty clause provides for royalty to be computed as (1) a specified fraction of (2) a specified value factor related to measured production. The Commission and respondents isolate out and concern themselves exclusively with the second factor. Due to the variability of the first factor, a lessee may, in fact, incur greater royalty costs from a lease which provides for payment as a fraction of the amount received under the producer's regulated rate than from one which expressly provides for a smaller fraction of a greater market value of natural gas. If the lessee's amount of leasehold production and all of its costs, other than royalty costs, were exactly the same under both leases and it then sought individualized relief, the Commission, under its understanding of *Texaco,* would flatly forbid rate relief under the second lease, even though the pass-through to the consumer would be a smaller amount than paid under the unobjectionable first lease. *Amici curiae* do not understand how the Commission and respondents can sensibly claim that such a result advances the objective of the Natural Gas Act of "afford[ing] consumers a complete, permanent and effective bond from excessive rates and charges." *Atlantic Refining Co.* v. *Public Service Comm'n,* 360 U.S. 378, 388 (1959).

Just as the per Mcf factor is just one of the factors in the royalty clause which governs the amount of periodic

cash rental payments, so, too, that entire clause itself is only one of the many terms and provisions of a multi-faceted integrated lease document. Each term and provision is essential to the whole, and each is related to the other in terms of consideration exchanged, including monetary consideration, such as initial "bonus" consideration, delay rentals and provisions for surface damages, etc. The Commission obviously cannot be permitted to take a bite out of this comprehensive real estate arrangement because to so do would spoil the whole of the unregulated transaction.

CONCLUSION

Any brief or presentation at this late stage cannot substitute for the shaping of issues of fact and law in an adversary proceeding necessary for a case and controversy ripe for decision by this Court. This case was not adversary, as the lessor was not present. Indeed, the lessor is a captive of the lessees under the terms of a settlement agreement which was conditional upon approval by a Commission that had no jurisdiction over the lessor or over the lease agreement.

Amici curiae are convinced that had either the petitioner or respondents been forthright, open and candid with this Court in their certiorari papers herein, this Court would not have granted the writ of certiorari. The parties assumed distorted facts and issues to make it appear that a justiciable controversy actually existed involving rights of absent lessors. They sought resolution of abstractly posed questions, any answer to which would have to be to their mutual benefit. This Court, now having been alerted to the lack of a justiciable case or controversy,

should dismiss the writ of certiorari granted herein, as having been improvidently granted.

Respectfully submitted,

Dale M. Stucky
Gerrit H. Wormhoudt
P. O. Box 997, 125 N. Market
Wichita, Kansas 67201

Of Counsel:

Kramer, Nordling & Nordling
P. O. Box 250
Hugoton, Kansas 67951

Mark E. Singer
Gregory J. Stucky
Fleeson, Gooing, Coulson & Kitch
P. O. Box 997, 125 N. Market
Wichita, Kansas 67201

In The

Supreme Court of The United States

October Term, 1978

No. 77-648

Federal Energy Regulatory Commission,

Petitioner,

v.

Pennzoil Producing Company, et al.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

RESPONDENT PENNZOIL PRODUCING COMPANY'S RESPONSE TO FILINGS BY MOBIL OIL CORPORATION AND LAWRENCE LIGHTCAP, ET AL.

John M. Young
General Attorney
Pennzoil Producing Company
3100 Pennzoil Place
Houston, Texas 77002

Jeron Stevens
Stephen M. Hackerman
Baker & Botts
3000 One Shell Plaza
Houston, Texas 77002
(713) 229-1234

Counsel for
Pennzoil Producing Company

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Respondent Pennzoil Producing Company (Pennzoil) recognizes that the filing of additional materials after submission of the briefs on the merits is not a favored practice. Pennzoil is compelled to file this response, however, in view of (1) the inappropriate and unsupported charges made in the Brief of Lawrence Lightcap, *et al.*, (Lightcap) and (2) the unfortunate and equally inappropriate attempt by Mobil Oil Corporation (Mobil) in its "Memorandum" to advance its own interest in a different case at the expense of the real parties in interest in this case.

Mobil and Lightcap are the opposing parties in *Mobil Oil Corp.* v. *Harry Lightcap, et al.*, No. 76-1694. Neither Mobil nor Lightcap have any direct interest in this case. Rather, to the extent they have any interest in this case it is solely to protect their positions in their own litigation.

Pennzoil recognizes that this case and the *Lightcap* case are in some measure related. It was with this recognition, and on the assumption that any participation by Mobil and Lightcap would be in an effort to advance the issues in this case, that Pennzoil did not object to Mobil's intervention in the court below and consented to Lightcap's request to file a brief *amicus curiae* in this Court. However, neither Mobil nor Lightcap has participated in a manner designed to aid this Court in the resolution of this case. Instead, Mobil and Lightcap have let their own interests spill over into this case regardless of whether it confuses the issues or delays resolution of this case. Thus, while Lightcap now suggests to this Court that the opposing parties in this case in fact have no controversy, Lightcap did nct participate before the Commission and, having seen the result reached before the Commission, did not participate before the court below. If Lightcap really believed or had any basis for the unfortunate and unfounded allegations of conspiracy it now makes, it would have attempted to protect its interests at a time far prior to submission of final briefs to this Court. Clearly, Lightcap's brief is not designed to aid the decision in this case, but to protect Lightcap's position in the *Lightcap* case.

Lightcap's charges that Pennzoil and the other parties to this case have not been "forthright, open and candid with this Court" (Lightcap Br. 26) and that there is no real controversy in this case because the parties have conspired to create an issue and hide the real facts from this Court are totally false. Charges so completely divorced from the truth could only be made by one who was not a party and who did not participate in any way at any stage of this matter.

Likewise, Mobil has not actively participated in this case either before the Commission or the court below. Indeed, Mobil did not even file a brief in the court below, nor did it file in opposition to the Commission's petition for a writ of *certiorari,* nor has it filed a brief on the merits in this case. Yet, without an interest sufficient to even cause Mobil to prepare any briefs in *this* case, Mobil now suggests this case be delayed indefinitely until *its* case (*Lightcap*) is decided. Mobil should not be allowed to delay resolution of this case simply to convenience itself in another case.

Furthermore, it is clear that this case can and should be decided regardless of *Lightcap*. The basic issue here is whether the Commission has authority to allow recovery of prudently incurred incremental royalty costs. Whether producers can be forced to make such royalty payments, which is the issue in *Lightcap,* is not at issue here. If this Court grants *certiorari* and reverses *Lightcap,* the question still remains whether the Commission has the authority to allow recovery of such costs if a producer agrees to such payments in an agreement deemed to be prudent. On the other hand, if this Court does not reverse *Lightcap,* the issue of the Commission's authority to allow recovery of such costs, whether incurred by settlement agreement or by court order, will remain. In short, while the two cases are related, this case and *Lightcap* are certainly not interdependent.

If Mobil is concerned about the timing of No. 76-1694, Mobil should seek to advance consideration in that docket. It is inappropriate for Mobil to serve its own ends by seeking to cause delay which could be harmful to the parties in this case.

For the foregoing reasons, Pennzoil respectfully requests that this Court deny Mobil's suggestion that this case be delayed.

Respectfully submitted,

JOHN M. YOUNG
General Attorney
Pennzoil Producing Company
3100 Pennzoil Place
Houston, Texas 77002

JERON STEVENS
STEPHEN M. HACKERMAN
Baker & Botts
3000 One Shell Plaza
Houston, Texas 77002

Counsel for
Pennzoil Producing Company

CERTIFICATE OF SERVICE

I hereby certify that I have served the foregoing on all parties on October 10, 1978, in accordance with the rules.

....
STEPHEN M. HACKERMAN